United States Court of Appeals

for the Second Circuit

APPENDIX

ORIGINAL

74-2582

United States Court of Appeals

For the Second Circuit

ROSALIND FOGEL, *et ano.*,

Plaintiffs- Appellants,

versus

GEORGE A. CHESTNUTT, JR., *et al.*,

Defendants- Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

APPENDIX

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PAGINATION AS IN ORIGINAL COPY

STATE OF NEW YORK)
COUNTY OF NEW YORK) ss.:

PEARL R. HARMON, being duly sworn, deposes and says, that on October 6, 1975, she served the within plaintiffs-appellants' reply to the Amicus brief upon the attorneys for the parties listed below in the within action, by enclosing true copies thereof in securely sealed postpaid wrappers addressed, respectively, as follows:

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and by depositing the same in the post office box regularly maintained by the United States Government at 295 Madison Avenue, New York, N.Y. 10017

Deponent further says that the above listed are the attorneys for the parties listed above and that the addresses set forth on said wrappers are the office and post office addresses given in the within action.

Pearl R. Harmon

Sworn to before me this
6th day of October, 1975

Rose Rosati

ROSE ROSATI
NOTARY PUBLIC, State of New York
No. 31-8638950
Qualified in New York County
Commission Expires March 30, 1976

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ONLY COPY AVAILABLE JUDGE ~~GURFEIN~~ Wyatt

	PROCEEDINGS	Date Order or Judgment Noted
-68	Filed complaint and issued summons.	
-68	Filed stipulation and order extending all defendants' time to answer complaint to 10/17/68,etc. So ordered. Mansfield,J.	
68	Filed summons with marshal's ret. Served:	
	John Currier personally on 7/22/68.	
	Stanley L. Sabel on 7/12/68.	
to	srv:Warren K. Greene by Doorman C. Stanbauer	
	Warren K. Greene, on 7/23/68 (District of Connecticut)	
	American Investors Fund, Inc. by John Newton, Treas. on 7/12/68.(Dist. of Conn.)	
	Chestnutt Corp. by John Newton on 7/12/68. " " "	
	American Investors Corp. by John Newton on 7/12/68. " " "	
	George A. Chestnutt, Jr. by his wife on7/12/68. " " "	
-68	Filed stip. & order extending time of defts. to answer to 20 days prior to Thursday, 12-19-68.-Ryan,J.	
-69	Filed ANSWER of defts. George A.Chestnutt,Jr., John Currier, Warren K.Greene, Stanley L.Sabel, American Investors Corp. and Chestnutt Corp. to complaint.	L'C&F
-69	Filed defts' memorandum in support of their motion to postpone discovery, etc.	
-69	Filed dofts' affdvt. & notice of motion to strike interrogatories-ret. 2-6-69	K&W
3-69	Filed Deft's ANSWER (AMERICAN INVESTORS ~~INC~~ FUND INC.,)	
-69	Filed Verified Responses of Defendants to Plaintiffs' Interrogs.	
4-69	Filed consent and order of substitution of atty. for defts.Chestnutt et al. So Ordered--Clerk.	
4-70	Filed pltffs' affidavit and notice of motion to consoldate for trial only with 67-60 ret. 5-5-70.	
-70	Filed stip that motion now ret. 5-5-70 be adjourned to 5-12-70 and that answering papers be served by 5-8-70.	
-70	Filed affidavit of Jerome J. Londin in opposition to pltffs' motion to consolidate (filed in 67-60).	
-70	Filed memorandum of law in ~~support~~ opposition to motion to consolidate (filed in 67-60)	
1-70	Filed affidavit of Allan F. Conwill in opposition to consolidation.	
1-70	Filed memorandum in opposition to motion for consolidation.	
1-70	Filed affidavit of William F. Koegel in opposition to consolidation.	
1-70	Filed affidavit of Clendon H. Lee in opposition to motion to consolidate. (filed in 67-70)	
1-70	Filed memorandum in opposition to consolidation motion(filed in 67-70)	
12-70	Filed memo.endorsed on motion to consolidate filed 4-24-70--Motion withdrawn. So Ordered--MetzNer, J.	
0-72	Filed Notice to take Depositions of George A. Chestnutt,Jr.,Warren K. Greene, and Stanley L. Sabel.	
4,72	Filed Pltff's Affdvt in opposition tomDefts'Motion for a protective Order.	
4,72	Filed Defts Memorandum in reply to answering Affdvt and in support of motion.	
14,72	Filed Defts Reply Affdvt,Clendon H. Lee.	
4,72	Filed Deft's (Chestnut Corp.et al) Notice of Motion for Protective Order pursuant to Rule 26(c)FRCP.	
14,72	Filed Memo End. on Notice of Motion,etc.as indicated,dated 12/14/72.This motion is referred to Hon.Gerard L.Goettel,U.S.Magistrate to hear and determine. All pretrial and discovery matters in this action are referred to Mag.Goettel. So Ordered. Wyatt.M/N	
14,72	Filed ORDER.Motion denied without prejudice to renewal should motion now pending in case of Fogel vs.Chestnutt be granted (67 Civ.60).Discovery proceed according to schedule provided in pltffs counsel's ltr of 11/2/72 except deft's answers to interrogs.should be served by 12/22/72 but depositions of defts need not commence until after 1/1/73.Further Ordered that discovery be concluded by 2/28/73 and parties be prepared for further settlement&pre-trial conf. on 3/5/73,10:00 A.M.Room 503. So Ordered.Goettel,Magistrate (Cont'd)	

DATE	FILINGS—PROCEEDINGS	A REPORT SMOLL NET M
Dec.18,73	Filed Pltffs.Notice of Deposition upon:	
	John Currier, 1/15/73,10:00 A.M.	
	Frank G.Fowler,1/16/73,10:00 A.M.	
	Richard W.Radcliffe,1/17/73,10:00 A.M.	
	Francis L.Veeder,1/18/73,10:00 A.M.	
Dec 20,73	Filed Pltffs Notice of Deposition upon:	
	Warren K.Greene,2/5/73,10:00 A.M.	
	Stanley L.Sabel,2/6/73,10:00 A.M.	
	George A.Chestnutt,Jr.2/17/73,10:00 A.M.	
Mar.26,73	Filed Notice of Depositions upon Warren K.Greene,Stanley L.Sabel,George A.	
	Chestnutt,Jr.by Pltffs.	
May 4,73	Filed Pltffs Interrogs.,3rd Series.	
May 6,73	Filed Pltffs.Notice to take deposition upon Harvey Pitt.	
May 8,73	Filed Pltffs.Notice of Deposition upon Peter Siberell.	
May 17,73	Filed Pltffs Notice of Deposition upon Thomas P.Phelan.	
Jun 5,73	Filed Pltffs request to produce(FRCP)	
Jun 26.73	Filed Deposition of dft. George A. Chestnutt Jr. dated 5/14/73.(m/n)	
Jun 26.73	Filed Deposition of Dft. George A. Chestnutt Jr. dated 5/8/73. (m/n)	
Jun 28.73	Filed Affidavit in answer by Clendon H. Lee of affidavit of Daniel W.	
	Krasner.	
Jun 28.73	Filed Pltffs. Notice of Motion. Re: Answer Interrogs. 3rd Series.	
	ret. 6/29/73.	
Jun 28.73	Filed Pltffs. Memorandum of law in support of the motion.	
July 9.73	Filed Deposition of Lloyd J. Derrickson dated 5/16/73. (m/n)	
Jul 29.73	Filed memo. end. on motion dated 6/28/73. This motion will be tried without	
	a jury & pltffs. & the real dfts having agreed, the issue of liability	
	will be tried separately & before the issue of damages. This being so,	
	there is no need to consider the alternative relief sought. Wyatt J.	
July 13.73	Filed Deposition of Richard W. Radcliffe dated 12/14/73 (m/n)	
July 13.73	Filed Deposition of Arnold J. Currier Jr. dated 12/14/73. (m/n)	
July 13.73	Filed Deposition of Frank G. Fowler Jr. dated 2/5/73. (m/n)	
Jul-25-73	Filed Pltffs. Notice of Motion. Re: Supplemental Complaint. ret.8/14/73	
Jul-25-73	Filed Memorandum of law in support of pltffs. FRCP 15(d) Motion.	
Jul-27-73	Filed Pltffs. Pretrial Memorandum	
Aug-14-73	Filed Memo. End. on Motion dated 7/25/73. Motion granted permitting pltffs.	
	to serve supplemental complaint) Wyatt J.	
Dec.4.73	Filed transcript of record of proceedings, dated Sept.4.5.6.10.11.1973.	

the following reasons:

Civil 2855 · Rosalind Fogel & Gerald Fogel, vs. George A. Chestnut, et al.

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DATE	FILINGS—PROCEEDINGS	AMOUNT REPORTED IN ENCUMBRANCE RETURNS	
Aug-20-73	Filed Defts. Notice of Motion. Re: Petition for Mandamus. ret. 9/24/73 (Defts. Chestnutt, et al.		
Aug-21-73	Filed Memorandum in opposition to defts. motion to postpone the trial.		
Aug-24-73	Filed Supplemental Complaint.		
Aug 30-73	Filed supplemental complaint & verification added		
Sep-11-73	Before Judge Wyatt 9/4/73 Trial begun continued 9/5,6,10,11/73 , adjourned to 10/ /73.		
Oct. 4-73	Filed pretrial order--consented to--Wyatt, J.		
Oct. 4-73	Before Wyatt, J.-Non-jury trial cont'd and concluded. Dec. Res.		
Sep.26-73	Filed notice of change of firm name for defts.		
Oct. 4-73	Filed pre-trial memorandum on behalf of deft. Chestnutt et al		
Nov.20.73	Filed Pltffs. Notice of Motion. Re: Correcting Transcrip of trial, etc. ret. 11/20/73.		
Dec.4.73	Filed Memo. End. on pltffs. motion dated 11/20/73. Motion granted on consent. Wyatt J. (mailed notice)		
Dec.4.73	Filed Post Trial Memorandum of Defts, Chestnutt et al.		
Dec.4.73	Filed Pltffs. Post Trial Memorandum.		
Dec.4.73	Filed Pltffs. proposed findings of fact & conclusions of law.		
12/4/73	Filed transcript of record of proceedings, dated 10/4/73		
6/28/73	PRE-TRIAL CONFERENCE HELD BY Wyatt.		
6/29/73	PRE-TRIAL CONFERENCE HELD BY Wyatt		
8/14/73	PRE-TRIAL CONFERENCE HELD BY Wyatt		
8/24/73	PRE-TRIAL CONFERENCE HELD BY Wyatt.		
Jan 15.74	Filed Defts Post Trial Reply Brief.		
Jan 15.74	Filed Defts. Counter Proposed Findings of Fact.		
Oct. 31-74	Filed letter dated 10-8-74 from Sec'y to Judge Wayt to Clendon H. Lee.		
Oct. 31-74	Filed letter dated 10-9-74 from Clendon H. Lee to Sec'y toJudge Wyatt.		
Oct. 31-74	Filed letter dated 7-17-74 from Clendon H. Lee to Judge Wyatt.		
Oct. 31-74	Filed letter dated 14-23-74 from Clendon H. Lee to Judge Wyatt.		
Oct. 31-74	Filed letter dated 4-17-74 from Richard M. Meyer to Judge Wyatt.		
Oct. 31-74	Filed letter dated 1-24-74 from Clendon H. Lee. to Judge Wyatt.		
Oct. 31-74	Filed letter dated 1-22-74 from Richard M. Meyer to Judge Wyatt.		
Oct. 31-74	Filed letter dated 1-18-74 from Clendon H. Lee to Judge Wyatt.		
Oct. 31-74	Filed letter dated 1-16-74 from Clendon H. Lee to Judge Wyatt.		
Oct. 31-74	Filed letter dated 1-15-74 from Daniel W. Krasner to Judge Wyatt.		
Oct. 31-74	Filed letter dated 10-9-73 from Richard M. Meyer to Judge Wyatt.		
Oct. 31-74	Filed pltffs' memorandum in response to defts' post -trial memorandum		

Continued

DATE	PROCEEDINGS	Dat No.
Nov 6.74	Filed Judgment. Ordered that defts. have judgment against the pltffs. dismissing the action on the merits. Clerk. E.(mailed notice)	
Dec 2.74	Filed Pltffs. Notice of appeal from judgment dtd. 11/6/74. (mailed notice)	
Oct 29.74	Filed Opinion #41376.The Clerk is directed to enter judgment in favor of defts. dismissing the action on the merits. So Ordered Wyatt J. (mailed notice)	
5-8-73	Filed notice to take deposition of Elkins Wetherill on 5-22-1973	
May 12 73	Filed notice to take deposition of Warren K. Greene et al.	
May 2 73	Filed notice of deposition of Martin Moskowitz.	
May 2 73	Filed notice to take of deposition of Lloyd Derekson	
May 2 73	Filed notice to take deposition of Fred Becker.	
Sep 16 68	Filed plaintiffs' interrog.	
Jan 1 69	filed notice of motion striking plaintiffs interrog.	
Feb 7 69	Filed memo endorsed on motion dtd 1-1-69, motion denied. So Ordered E. Weinfeld J.	
Jan 3.75	Filed Stip that all pltffs. & defts. exhibits accepted shall be transmitted to the C/A USCA & be included in the record on appeal.	
Jan 7.75	Filed Stip & Order that the time to transmit the record on appeal is enlarged from 1/13/75 to 2/10/75. So Ordered Wyatt J.	
Jan 27.75	Filed Stip & Order that the time to transmit the record on appeal is enlarged from 2/10/75 to 3/3/75. So Ordered Wyatt J.	
Feb 27.75	XXXXXX Certified Record to the USCA	

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

----------X

ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs,

-against-

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREENE, RICHARD W. RADCLIFFE, STANLEY L. SABEL, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, CHESTNUTT CORPORATION and AMERICAN INVESTORS FUND, INC.,

Defendants.

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68 Civ. 2855 (IBW)

SUPPLEMENTAL COMPLAINT

PLAINTIFFS DEMAND TRIAL BY JURY

Plaintiffs, for their complaint, allege upon information and belief, except as to ¶ 2 which they allege upon knowledge:

1. This action arises under the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 et seq. (the "1940 Act"), the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 et seq. (the "Advisers Act"), and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq. (the "1934 Act"). The jurisdiction of the Court is based on all three Acts.

2. (a) Plaintiffs jointly were shareholders of defendant, American Investors Fund, Inc. (the "Fund") and plaintiff Rosalind Fogel has been and is a shareholder since at least 1963 and at the times of the wrongs complained of herein.

(b) Plaintiffs bring this action derivatively on behalf of the Fund and representatively on behalf of themselves and all other shareholders of the Fund similarly situated.

(c) This action is not brought collusively to confer upon this Court jurisdiction which it otherwise would not have.

3. The Fund is a New York corporation. It is and at all times relevant herein has been registered under the Act as a diversified open-end management investment company.

4. (a) The individual defendants comprise the Fund's board of directors.

(b) In addition to their being directors of the Fund, defendant George A. Chestnutt, Jr. is president of the Fund; defendant Stanley L. Sabel is vice president and secretary of the Fund.

5. Defendant Chestnutt Corporation (the "Investment Adviser"), a Connecticut corporation, is the successor in interest to American Investors Corporation. Defendant George A. Chestnutt, Jr. is president, treasurer and a director of the Investment Adviser, and owns about forty-six (46%) per cent of its voting stock. Defendant Stanley L. Sabel is vice president, secretary and a director of the Investment Adviser, and owns about sixteen (16%) per cent of the voting stock. Defendant John Currier owns about two (2%) per cent of the voting stock of the Investment Adviser.

6. For the years ended December 31, 1963, 1964, 1965, 1966, 1967, 1968, 1969, and 1970, the Fund paid the Investment Adviser and its predecessor, American Investors Corporation, pursuant to an investment advisory contract, investment advisory fees of $93,347, $187,083, $337,626, $529,663, $1,087,993, $1,464,000, $1,557,000, $1,175,000. -2-

now receives substantial additional compensation by the use of a device known as "reciprocal brokerage". Reciprocal brokerage is the awarding of brokerage commissions resulting from the Fund's portfolio transactions to those brokers and dealers who sell Fund shares to the public and who supply research and investment advice to the Investment Adviser. Reciprocal brokerage was abolished by the NASD on May 25, 1973 effective July 15, 1973.

8. The assets of the Fund are invested in securities which are traded on the national securities exchanges and in the over-the-counter market. In the purchase and sale of such securities the Fund has paid substantial brokerage commissions. The Fund pays such brokerage commissions to brokers and dealers who sell its shares and who supply research and investment advice to the Investment Adviser. In 1964, 1966, 1967, 1968, 1969, and 1970, the Fund paid brokerage fees of $275,000, $387,000, $551,668, $1,995,087, $3,122,160, $2,489,281, $2,059,234 respectively. Of such commissions the Fund allocated approximately $162,000, $247,000, $261,913, $935,966, $2,022,457, $1,196,059, $1,108,667 during the years 1964 through 1970 to brokers who provided helpful information to the Investment Adviser and approximately $113,000, $140,000, $289,755, $1,059,121, $1,099,703, $1,293,222, $950,000, in the years 1964 through 1970 to brokers who assisted the Investment Adviser in the sale of Fund shares.

9. The Investment Adviser's power to allocate the Fund's brokerage commissions is a power in trust which must be used for the benefit of the Fund and not for the benefit of the Investment Adviser.

10. By awarding reciprocal brokerage, the Investment Adviser and the individual defendants benefit themselves by stimulating sales of the Fund's shares. Such sales increase the total assets of the Fund and thus increase the profits which the defendants are able to earn through the investment advisory contract with the Fund. Such sales, however, result in no benefit to the Fund or its shareholders.

11. By awarding reciprocal brokerage, the Investment Adviser is also benefited by receiving advisory services from those brokers and dealers who receive the commissions from the Fund. As adviser to the Fund, the Investment Adviser is required to furnish these advisory services. The Investment Adviser is thus able to utilize the services of these brokers to fulfill its obligations to the Fund at the Fund's expense rather than its own.

12. An affiliate of the Fund or the Investment Advisor could be empowered to act as the Fund's broker and save a portion of the very substantial brokerage commissions it is forced to pay. The reason this is not done is that the Investment Adviser prefers to profit from such brokerage transactions and to pay its obligations by awarding the Fund's brokerage commissions to others.

13. The practice of reciprocal brokerage results and has resulted in compensation to the Investment Adviser that exceeds the amounts provided for in the investment advisory contract, and thus exceeds the compensation permitted by the 1940 Act.

14. Those brokers who execute portfolio transactions for the Fund are willing to execute such transactions for less than the commissions paid to them. In fact, in many cases such brokers do execute transactions for less than the commissions paid to them, giving up the balance to brokers and dealers who sell Fund shares, or supply services to the Investment Adviser, at the direction of the Investment Adviser. Brokers and dealers who receive such "give-ups' perform no services of value in connection with the execution of portfolio transactions on which commissions are paid.

15. Those amounts paid as "give-ups" could have and should have been returned to the Fund either by direct payment to the Fund or by crediting them against advisory fees otherwise payable by the Fund. Failure to so return these excess portions of the brokerage commissions constitutes an appropriation of the assets of the Fund by the Investment Adviser in violation of the 1940 Act, and constitutes a violation of the anti-fraud provisions of the 1934 Act and the Advisers Act. Give-ups were abolished on December 5, 1968.

16. The Fund purchases and sells a substantial amount of securities of companies who securities are not listed on a national securities exchange and are traded exclusively in the over-the-counter market. The Fund makes purchases and sales of such securities through brokers and dealers who sell Fund shares or supply research and investment advice to the Investment Adviser. For the execution of these transactions, the Fund has paid and continues to pay those brokers and dealers substantial brokerage commissions and mark-ups and mark-downs.

17. In so executing transactions, the Fund has failed to obtain the most favorable prices and executions for the purchase and sale of portfolio securities. Instead, the Fund has interposed those brokers and dealers who sell its shares and supply advice between the Fund and those brokers and dealers and others from whom the most favorable prices and executions were available.

18. The brokerage commissions and mark-ups and mark-downs paid by the Fund for the execution of over-the-counter transactions are gratuitous payments to those brokers and dealers who sell Fund shares and supply advice for which no service of value to the Fund is rendered. They consist of charges for transactions executed in the over-the-counter market with "market makers" (i.e., dealers who advertise their willingness to buy and sell particular securities) and others, all of whom would have dealt directly with the Fund on the same basis as they dealt with the brokers and dealers who sell Fund shares and supply advice. By dealing directly with the former, the Fund could have saved the commissions, mark-ups and mark-downs paid to the latter. The reason that the Fund makes virtually all of its over-the-counter purchases and sales through such brokers and dealers is that the Investment Adviser dominates and controls the Fund and prefers to profit at the Fund's expense.

19. Payments of brokerage commissions, mark-ups and mark-downs by the Fund for the execution of over-the-counter transactions is an appropriation by the Investment Adviser and the individual defendants of the Fund's assets in violation of the anti-fraud provisions of the 1934 Act and the Advisers Act.

20. The right to choose the Fund's broker and the method of trading the Fund's portfolio securities belongs to the Fund. By diverting this opportunity to themselves, the Investment Adviser and the individual defendants have prevented the Fund among other things from (a) conducting its own brokerage business; and (b) obtaining the best commission rates for the purchase and sale of its portfolio securities.

21. As a result of the desire of the Investment Adviser to utilize reciprocal brokerage commissions, opportunities have been foregone to execute transactions for the Fund in the so-called "Third Market" where the total cost of executing portfolio transactions is often less than the total costs of executing the same order on a national securities exchange. Similarly, the Fund has foregone opportunities to utilize brokers who would execute transactions more advantageously.

21(a) The Fund or the Investment Adviser could have organized an affiliate for the purpose of reducing the net brokerage commissions paid by the Fund. This affiliate could have recaptured the Fund's brokerage commissions on various regional exchanges since at least January, 1965. Defendants Chestnutt, Sabel, and Greene intentionally mislead and misinformed the Fund's unaffiliated directors by telling them that such recapture was not available to the Fund.

22. As a result, payment of these commissions, mark-ups and mark-downs by the Fund violates § 37 of the 1940 Act in that money and assets of the Fund have been and are being unlawfully and willfully converted by the Investment Adviser and the individual defendants, and such payment constitutes a violation of § 10(b) of the 1934 Act and § 206 of the Advisers A

23. In addition, the aforesaid acts have been and are a gross abuse of trust, bad faith, gross negligence and a disregard by the Investment Adviser and the individual defendants of the fiduciary duties which are imposed on them by the 1940 Act and §§ 1(b) (2), 10, 17(e) (1), 17(h), 17(i) and 36 in particular.

23(a) The wrongs alleged herein are continuing wrongs. They have continued up to the date of this supplemental complaint and are still continuing.

24. Any demand on the Fund's board to bring this action would be futile and is unnecessary because:

(a) The defendant directors are the principal wrongdoers herein, some of whom have personally profited from the wrongs alleged in this complaint;

(b) A majority of the Fund's directors took part in the wrongs alleged herein; and

(c) The directors are and would be hostile to the successful prosecution of the instant lawsuit.

25. Demand upon the Fund's shareholders to bring this action would be futile and is unnecessary for at least the following reasons:

(a) The wrongdoings alleged herein violate the 1940 Act, the 1934 Act and the Advisers Act, and are a waste of the Fund's assets, and hence are incapable of shareholders' ratification.

(b) The Fund has many thousands of shareholders scattered all over the United States and foreign countries. Their identity is subject to frequent changes. To secure action from the shareholders would require a proxy fight with management

which controls the proxy machinery of the Fund and uses the Fund's monies in preparing and mailing proxy material and soliciting votes. The conduct of a proxy fight would entail prohibitive expenses and would cause undue loss of time with the danger that the claims herein alleged might become barred by the statute of limitations or laches.

WHEREFORE, plaintiffs pray for judgment:

1. Enjoining defendants temporarily and permanently from continuing their unlawful conduct alleged herein;

2. Requiring defendants jointly and severally to pay to the Fund the illegal and excessive brokerage commissions paid by the Fund;

3. Requiring defendants jointly and severally to pay to the Fund and its shareholders their damages and the profits derived by defendants from the wrongful actions alleged herein;

4. Allowing plaintiffs their costs and expenses of this action, including reasonable counsel fees; and

5. Granting plaintiffs such other and further relief as may be just.

Dated: New York, N. Y.,
July 25, 1973

POMERANTZ LEVY HAUDEK & BLOCK
Attorney for Plaintiffs
295 Madison Avenue
New York, New York 10017
LE-2-4800

STATE OF NEW YORK)
: SS.:
COUNTY OF KINGS)

ROSALIND FOGEL being duly sworn, deposes and says: that she is the plaintiff in the within action. That she has read the foregoing supplemental complaint and knows the contents thereof; that the same is true to her own knowledge, except as to matters therein stated to be alleged on information and belief, and that as to those matters she believes them to be true.

ROSALIND FOGEL

Sworn to before me, this

day of , 1973.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

- x

ROSALIND FOGEL and GERALD FOGEL, :

Plaintiffs, :

-against- :

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, :
FRANK G. FOWLER, JR., WARREN K. GREENE,
RICHARD W. RADCLIFFE, STANLEY L. SABEL, :
FRANCIS L. VEEDER, AMERICAN INVESTORS
CORPORATION, CHESTNUTT CORPORATION and :
AMERICAN INVESTORS FUND, INC.,

Defendants. :

- x

68 Civ. 2885

ANSWER

Defendants GEORGE A. CHESTNUTT, JR., JOHN CURRIER, WARREN K. GREENE, STANLEY L. SABEL, AMERICAN INVESTORS CORPORATION and CHESTNUTT CORPORATION, by their attorneys O'CONNOR & FARBER, answering the complaint herein, respectfully show and allege:

1. Deny each and every allegation contained in paragraph "1".

2. Deny the allegations of paragraph "2(a)", except admit that the records of AMERICAN INVESTORS FUND, INC., (the "Fund"), show shares standing in the names of ROSALIND FOGEL and GERALD FOGEL purchased through January 20, 1967 on the following dates and in the following amounts and numbers of shares:

Date	Number of Shares	Price Per Share	Total Cost	Cumulative Number of Shares
1/11/63	14.085	$14.20	$200.00	14.085
11/4/64	10.724	18.65	200.00	24.809
3/14/64	1.281	19.37	24.81	26.090
12/8/64	9.597	20.84	200.00	35.687
3/26/65	0.385	23.19	8.92	36.072
6/25/65	0.412	21.89	9.02	36.484
9/24/65	0.381	23.91	9.12	36.865
12/24/65	0.313	29.46	9.22	37.178
3/18/66	0.568	32.72	18.59	37.746
5/12/66	6.163	32.45	200.00	43.909
11/23/66	7.278	27.48	200.00	51.187
1/20/67	1.068	29.71	31.74	52.255

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Deny knowledge or information sufficient to form a belief as to the truth of the allegations contained in subparagraphs "2(b)" and "2(c)".

3. Admit the allegations of paragraph "3".

4. Admit the allegations of paragraph "4".

5. Admit the allegations of paragraph "5" as being true at the time of the complaint; except allege that certain changes have occurred in the percentages therein referred to since that date; and except deny that CHESTNUTT CORPORATION ("the Investment Adviser"), is the successor in interest to AMERICAN INVESTORS CORPORATION, and allege that CHESTNUTT CORPORATION acquired the assets of AMERICAN INVESTORS CORPORATION, subject to its liabilities, on or about July 19, 1966, and that AMERICAN INVESTORS CORPORATION was thereafter dissolved.

6. Admit the allegations contained in paragraph "6".

7. Deny the allegations contained in paragraph "7".

8. Deny each and every allegation contained in Paragraph "8", except admit that the assets of the Fund are invested in securities which are traded on national securities exchanges and in the over-the-counter market and that the Fund in making such investments has been required to pay brokerage commissions. Defendants allege that all purchases of or subscriptions for Fund shares are made through The Bank of New York, as agent for the purchaser, or by direct purchase or subscription from the Fund. Defendants allege that in accordance with its prospectus, the Fund places orders for transactions in portfolio securities with brokers or dealers providing the most favorable prices and executions available.

Speed and accuracy in obtaining market quotations, promptness in execution of orders at minimum commission rates, and prompt reporting of executions are absolutely essential. Among such brokers and dealers, those who have provided helpful information to the Fund, or have assisted in the sale of Fund shares, are given preference (without agreement to do so) in allocating brokerage business, but not at any sacrifice in price or execution, and whether or not such preference were given, the Fund would have to pay the same amount of commissions. Such helpful information obtained from brokerage sources involves quick, accurate quotations and data as to the size of the market; newly obtainable data on money statistics, earnings projections, dividend prospects; probable sellouts, mergers, consolidations, and liquidations; general tape action, with volume of shares, blocks recently traded or to be traded, who the buyers and sellers are believed to be, and other information as to the state of the market at a particular moment. Brokerage commissions of $387,000 were charged to the Fund on purchases and sales of the Fund's portfolio securities in 1965, $551,668 in 1966, and $1,995,087 in 1967. Of such amounts the Fund allocated approximately $247,000 in 1965, $261,913 in 1966, and $935,966 in 1967, as paid to brokers who provided helpful information, and approximately $140,000 in 1965, $289,755 in 1966, and $1,059,121 in 1967, as paid in connection with the sale of Fund shares.

9. Deny that the Investment Adviser has power to allocate the Fund's brokerage commissions, and allege that the Fund has power to allocate brokerage commissions and that the Fund has exercised its power for the benefit of the Fund, and deny any implication that allocation of the Fund's brokerage commissions may be for the benefit of the Investment Adviser; and except as herein admitted, deny each and every allegation contained in Paragraph "9".

10. Deny each and every allegation contained in Paragraph "10", and allege that sales by the Fund of its shares benefit the Fund and its shareholders in many respects, including reducing the proportionate expense per share of operating the Fund and the proportionate expense per share for investment advice, by furnishing liquid assets for advantageous investments, providing liquid funds for redemption by shareholders desiring to redeem their share in the Fund without the necessity of liquidating portfolio investments for other than investment reasons, by affording means of assuring continuity of expert management and advice and enables the Adviser to hire employees of talent and ability, and further allege that all matters relating to the size of the Fund and the sales of its shares are matters of business judgment of the Fund's directors and officers.

11. Deny each and every allegation contained in Paragraph "11"; defendants repeat the denials and allegations contained in Paragraph "8" of this answer, and further allege that when economic information relating to particular investment situations is offered to the Fund by a broker to stimulate business, it is the practice of the Fund upon receiving such information from brokerage sources to refer such information to its Investment Adviser for verification and opinion as to validity, accuracy, and for further research and recommendation as to the desirability of acting upon such information, all of which involves independent work by the Adviser with related costs, and to the extent such information can be utilized, such information can aid the Adviser in achieving better investment performance for the Fund.

a captive sales force) with $2.6 billion of assets, secured member-

12. Deny that the Fund could be empowered to act as its own broker directly. Defendants allege that the Fund's management as a matter of judgment has not injected the Fund indirectly or through subterfuge and indirectly through affiliates into the unsettled, confusing and contradictory policies and regulations of certain regional exchanges where minor portions of the Fund's portfolio transactions are affected; and further allege that the Fund cannot act as its own broker indirectly or through subterfuges in the principal and major markets where the Fund effects portfolio transactions. Defendants further allege that were the Fund to take any steps attempting to act as its own broker indirectly and through subterfuge in any minor markets that the Fund's investment success in achieving the objectives set forth in its prospectus would be seriously impaired and its operations impeded through immediate informing of competing investors of the Fund's portfolio transactions; would militate against obtaining the best execution services from full-time, professional, competitive brokers; and would devote its valuable investment management talent to unproductive effort, lead to possible duality of interest and impose unwarranted risk and expense upon the Fund for a conjectural return by no means certain to be achieved. Except as herein admitted, defendants deny each and every allegation contained in paragraph "12".

13. Deny each and every allegation contained in Paragraph "13".

14. Deny each and every allegation contained in Paragraph "14", and allege that the Fund is compelled to execute orders on national securities exchanges at the prescribed minimum commission rates; and further allege that

where, in accordance with the minimum rates and the rules of such exchanges which have been approved and mandated by the Federal Securities and Exchange Commission, certain brokers have paid over portions of commissions in accordance with such rules and regulations to other brokerage firms, that such payments have been made for the benefit of the Fund and the achievement of its investment objective, including the assurance of the most favorable prices, the best executions of orders, the stimulation of timely and accurate market and other information, and the flow of adequate liquid capital to take advantage of investment opportunities and provide for the redemption of shares, as well as to effect a proportionate reduction in the expense per share of operating the Fund through growth of the Fund's assets.

15. Deny each and every allegation contained in Paragraph "15".

16. Deny each and every allegation contained in Paragraph "16", except admit that the Fund purchases and sells a substantial amount of securities in the over-the-counter market; and allege that such securities have been acquired at such net prices or upon payment of such brokerage commissions as in the judgment of the Fund and the adviser have been advantageous to the Fund in the light of market conditions obtaining at the times of such transactions, and in accordance with customary and required practices obtaining in such markets.

17. Deny each and every allegation contained in Paragraph "17."

18. Deny each and every allegation contained in Paragraph "18."

19. Deny each and every allegation contained in Paragraph "19."

20. Deny each and every allegation contained in Paragraph "20"; and allege that the Fund has chosen its brokers and conducted its portfolio transactions in the interest of the Fund and in accordance with its best judgment and the best judgment of the adviser.

21. Deny each and every allegation contained in Paragraphs "21," "22," "23," "24," "25."

FIRST AFFIRMATIVE DEFENSE

22. The court lacks jurisdiction over the subject matter of this action in that there is no allegation of diversity of citizenship and in that there is no statement of a claim for declaratory relief or claim of wrong or injury upon which relief can be granted.

SECOND AFFIRMATIVE DEFENSE

23. The complaint fails to state a claim under the Constitution, Laws or Treaties of the United States, or upon which relief can be granted under the Investment Company Act of 1940 (15 U.S.C. §80a-1 et seq.), the Investment Advisers Act of 1940 (15 U.S.C. §80b-1 et seq.), and the Securities Exchange Act of 1934, (15 U.S.C. §78a et seq.), and to the extent the complaint purports to state a representative claim, it fails to state a claim upon which relief can be granted.

THIRD AFFIRMATIVE DEFENSE

24. Defendants repeat and reallege each and every denial and allegation contained in this answer.

25. Plaintiffs do not fairly and adequately represent the interests of shareholders similarly situated in enforcing the purported claims in the right of defendant Fund, and this action may not be maintained by plaintiffs either derivatively or representatively.

FOURTH AFFIRMATIVE DEFENSE

26. Defendants repeat and reallege each and every denial and allegation contained in this answer.

27. The Fund has received the benefit of brokerage services equal in value to the brokerage commissions paid by it at the regular, customary and required minimum rates for transactions on national securities exchanges, and the Fund has received the benefit of brokerage services equal in value to brokerage commissions paid by it in accordance with regular and customary rates obtaining in other markets, all in accordance with rules and regulations of national securities exchanges and associations authorized and empowered by law to determine brokerage practices, rates and procedures, and this action may not be maintained.

FIFTH AFFIRMATIVE DEFENSE

28. Defendants repeat and reallege each and every denial and allegation contained in this answer.

29. The manner in which the Fund has selected brokers to effect portfolio transactions has been disclosed to plaintiffs and all other shareholders in prospectuses and other written publications received by plaintiffs and other shareholders, both prior to the time plaintiffs became shareholders in the Fund and continuously thereafter during which period of time plaintiffs have continued to purchase shares of the Fund, and plaintiffs and all others similarly situated are estopped to maintain this action and have ratified and confirmed the acts complained of, and this action may not be maintained either derivately or representatively.

SIXTH AFFIRMATIVE DEFENSE

30. Defendants repeat and reallege each and every denial and allegation contained in this answer.

31. The Fund has not been deprived of any benefit and has suffered no injury as a result of the acts complained of, and this action may not be maintained.

WHEREFORE, these defendants demand judgment dismissing the complaint, together with costs and disbursements of the action.

Dated: January 17, 1969

O'CONNOR & FARBER

By Clendon H. Lee

Clendon H. Lee
Member of the Firm
Attorneys for Defendants
George A. Chestnutt, Jr.
John Currier
Warren K. Greene
Stanley L. Sabel
American Investors Corporation
Chestnutt Corporation,
Office and Post Office Address
120 Broadway
New York, N.Y. 10005
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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

ROSALIND FOGEL and GERALD FOGEL, Plaintiffs, -against- GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREENE, RICHARD W. RADCLIFFE, STANLEY L. SABEL, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, CHESTNUTT CORPORATION and AMERICAN INVESTORS FUND, INC., Defendants.	68 Civ. 2885 ANSWER

Defendant AMERICAN INVESTORS FUND, INC., by its attorneys Royall, Koegel & Wells, for its answer to the Complaint states that no charges are made against it in the Complaint and that it submits its rights to the Court and asks the Court to make such judgment and decree herein with respect to said defendant as may be just and proper.

ROYALL, KOEGEL & WELLS

By s/ William M. Koegel
A Member of the Firm
Attorneys for Defendant
American Investors Fund, Inc.
Office and P.O. Address
200 Park Avenue
New York, New York 10017

Telephone: 972-7000

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs,

-against-

GEORGE A. CHESTNUTT, JR., et al.,

Defendants.

----------X

68 Civ. 2855 IBW

PRETRIAL ORDER

By order of this Court the issue of liability is being tried separately and before the issue of damages and the right to a jury trial has been waived by both parties.

1. The pleadings have been deemed amended and supplemented by plaintiffs' supplemental complaint dated July 25, 1973. Plaintiffs' motion pursuant to FRCP 15(d) permitting them to serve this supplemental complaint was granted by order of this Court dated August 14, 1973.

2. Plaintiffs abandon no issues raised in this supplemental pleading.

3. The following has been stipulated by counsel for all parties:

American Investors Fund (the "Fund") is a New York corporation. It is, and at all times relevant has been registered under the Investment Company Act as a diversified open-end management company.

("Management Co.")

Defendant Chestnutt Corporation, /the Fund's manager and investment adviser, is a Connecticut corporation. It acts as the Fund's investment adviser pursuant to an investment advisory agreement. On July 19, 1966 it acquired the assets of defendant American Investors Corporation, the Fund's previous investment adviser, subject to American Investors Corporation's liabilities. Both American Investors Corporation and Chestnutt Corporation had the same officers, directors and stockholders and each stockholder held the same proportionate interest in both corporations at the time of the merger.

The records of American Investors Fund, Inc. show shares standing in the names of Rosalind Fogel and Gerald Fogel since January 11, 1963. They continue to show them as shareholders of record to the present time.

At the time the complaint herein was filed the stockholders of Chestnutt Corporation included defendants Chestnutt, Sabel, Greene and Currier. A 1% stock interest in Chestnutt Corporation (and its predecessor) has been held by the wife of Clendon H. Lee since approximately 1960. In 1965 Clendon H. Lee commenced acting as Special Counsel to the Fund & Chestnutt Corp. in various matters. The aforesaid defendants and Clendon H. Lee had the following approximate percentage interest in the voting stock of Chestnutt Corporation:

George A. Chestnutt, Jr.	47%
Stanley L. Sabel	16%
John Currier	2%
Clendon H. Lee (attributed)	1%
Warren K. Greene	0.4%

At all times relevant herein: Defendant George A. Chestnutt, Jr. was president and director of the Fund. He was also president, ~~treasurer~~ and a director of Management Co.

Defendant Stanley L. Sabel was senior vice president, secretary and a director of the Fund. He was also vice president, secretary, general counsel and a director of Management Co. Commencing about 1966, the firm of Sutton, Sabel & Schupp, in which defendant Sabel was a partner, became legal counsel to the Fund. In 1971 defendant Sabel resigned all offices with the Fund, except his directorship.

Defendant, Warren K. Greene was vice president and director of the Fund, and vice president of Management Co. in 1967.

Management Co. acts as the Fund's manager and investment adviser under an investment advisory agreement. At the time, plaintiffs' first purchased Fund shares, the advisory fee was 1%. For the period July 21, 1964, through July 16, 1968 the advisory fee schedule was:

Annual Rate	Total Net Asset Value
0.8%	First $50 million
0.6	Next $50 million
0.4	Next $100 million
0.3	Next $100 million
0.25	Next $100 million

On July 16, 1968, the fee schedule was raised to:

Annual Rate	Total Net Asset Value
0.8 of 1%	First $50 million
0.6 of 1%	Next $50 million
0.4 of 1%	Next $200 million
0.35 of 1%	Next $200 million

It has remained at that level to date. The advisory fees paid to Management Co. for the years 1964 through December 31, 1970, were as follows:

1964	$ 187,000
1965	337,000
1966	529,000
1967	1,087,000
1968	1,464,000
1969	1,557,000
1970	1,175,000

In addition to defendant Chestnutt, the other directors of the Fund since 1965 included defendants, Stanley Law Sabel, John Currier and Warren K. Greene. Frank G. Fowler, Richard Radcliffe, Elizabeth Sullivan, Francis L. Veeder* and William A. Semmes were also directors of the Fund during part or all of this period but they are not defendants in this action. Elizabeth Sullivan was employed by Management Co.

Clendon H. Lee was special counsel to, and a director of, Management Co. He became special counsel to the Fund in 1965. Since 1967 he has acted as counsel for all directors served in Fogel v. Chestnutt, 67 Civ. 60. and is counsel for all the defendants in this action aside from the Fund.

In early 1965, Waddell & Reed, Inc., manager of a large mutual fund complex of load funds (which are distributed by a captive sales force) with $2.6 billion of assets, secured membership on the Pacific Coast Stock Exchange for a subsidiary. The subsidiary arranged for the execution of the portfolio brokerage business of the funds. Waddell & Reed reduced the advisory fees of the funds under its management by 50% of the subsidiary's brokerage profits, and thus enabled the funds to recapture part of their portfolio brokerage.

In early 1965, Investors Diversified Services, Inc., a manager of load funds with aggregate assets of $6.1 billion, procured Pacific Exchange membership for a subsidiary. The entire brokerage profits of the subsidiary, more than $4,100,000 in 1967, were passed along to the funds by an equivalent reduction of their advisory and service fees.

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* Mr. Veeder is recently deceased.

Similar arrangements were made by the Channing complex and by Imperial Financial Services, both of which manage load funds.

The applications of IDS and Waddell & Reed received publicity in The New York Times and Wall Street Journal during 1965.

Subsequent to the filing of an action by these identical plaintiffs in this Court, against these defendants and others in January, 1967, (67 Civ. 60) which claimed, among other things, impropriety in connection with brokerage commissions charged on Fund portfolio transactions, Messrs. Sabel and Lee advised all of the directors of the Fund and the Adviser on numerous occasions, including meetings of such Boards, that no impropriety had been found in connection therewith. On or about February 1968, upon the issuance by the Securities and Exchange Commission of its 1934 Act Release No. 8239 dated January 26, 1968 proposing a new Rule 10b-10 (which proposal the Commission later withdrew), Messrs. Sabel and Lee specifically advised all of the directors of the Fund and the Adviser that the suggested form of "recapture" contained in such proposed, but never adopted, new Rule 10b-10 by its express terms applied only to "dealer-distributed funds", rather than a no-load fund such as the Fund which has no "distributor" or "underwriter", and Messrs. Sabel and Lee advised that the question of possibility of recapture of brokerage commissions which the Fund is compelled to pay upon execution of portfolio transactions does not arise.

There are no writings reflecting any discussions or deliberations by any of the Fund's directors with respect to recapture.

No objection will be made as to the authenticity of copies of prospectuses of other investment companies. If a responsible officer of an investment company whose prospectus is offered in evidence were called to testify he would testify that such prospectus accurately reflected the books and records of such investment company.

(b) Plaintiffs' contentions are:

1) The brokerage commissions growing out of the purchase and sale of securities by American Investors Fund (the "Fund") were in large part recapturable by the Management Co., Chestnutt Corporation. At least the Philadelphia Exchange and the Pacific Exchange (both regional exchanges) permitted mutual funds to recapture commissions on transactions executed on those exchanges. Since early 1965 mutual funds have been recapturing substantial amounts of commissions, through their management companies.

2) Recapture by mutual funds was urged by the SEC beginning at least in 1966.

3) All recapturable commissions constituted assets of the Fund and could and should have been recaptured because

(a) The Fund's Certificate of Incorporation requires that the Fund receive full net asset value for each share sold (Plaintiffs' pre-trial memo.pp.28-30). Net asset value includes not only the tangible assets of the Fund but, as well, all amounts receivable by the Fund including all recapturable commissions: Moses v. Burgin, 445 F.2d 369, 374 (1st Cir.1971); cert.den.sub nom. Johnson v. Moses, 404 U.S. 994;

Management Co. to secure it at its expense (not through the use of the Fund's commissions).

In any event, even assuming, arguendo, that the Fund's commissions could be used to effect sales, and to purchase additional research, the decision so to do did not lie with the affiliated directors of the Fund, but with its unaffiliated, or independent, directors properly informed of the Fund's power to recapture.

As a consequence of the foregoing, the Management Co.'s failure to recapture the Fund's brokerage commissions for the Fund constituted a violation of the Investment Co. Act.

Defendants' Contentions:

1. Each contention of plaintiffs in the pretrial order is denied.

2. It is plain that the entire complaint has been abandoned, notwithstanding plaintiffs' assertion otherwise, and that the only issue proffered to the Court is set forth in paragraph 21(a) of the Supplemental Complaint; namely, that defendants should have gone into the brokerage business, or alternatively should have engaged in subterfuge through a sham entity or sham transaction.

3. The Fund was required to execute its portfolio transactions at the required minimum commission rates on various exchanges, and until recently no part of such commission rates was negotiable, and after such rates did become negotiable in part, the Fund has properly negotiated that portion.

4. Neither the Fund nor its shareholders was injured, and for brokerage commissions paid by the Fund it received brokerage services, and no part of any such brokerage commissions was ever paid over to any defendants.

5. It was to the advantage of the Fund and its shareholders to obtain new subscriptions in order to provide funds for redemption of shares, for the Fund to grow and thereby spread necessary expenses more widely, and to provide new money for advantageous investment.

6. All prospectuses and proxy statements wherein the Fund's brokerage practices were described were extensively reviewed and approved by all members of the Board of Directors of the Fund.

7. The directors of the Fund individually and collectively opposed the Adviser's entering into the brokerage business with the necessary diversion of effort, talent and resources to a new and different business and the conflict of interest inherent in self-dealing.

8. All defendants and directors have known from the inception of the Fund until the present that the Fund is a no-load fund and there has never been any occasion for the creation of an "underwriter" or "dealer" to distribute the Fund's shares, all of which are purchased directly from the Fund (including the Bank of New York as transfer agent).

9. The new business activities and adventures which plaintiffs claim defendants should have engaged in are now effectively prohibited to the Fund by the SEC as a matter of public policy and the defendants are precluded from engaging in such activities, and responsible committees of both houses of Congress have recommended that the practices which plaintiffs claim defendants should have e[illegible]n should be flatly prohibited by statute.

10. At all relevant times defendants and all directors exercised their sound business judgment in not changing the Fund's method of doing business.

11. At all relevant times the Fund directors were advised by experienced general counsel and also by special counsel, both of whom had reasonable basis for their advice. Even if such advice were mistaken, and even if the SEC should reverse itself, and even if committees of both houses of Congress should reverse themselves, plaintiffs cannot successfully contend that such advice was not reasonable and that the directors and other defendants could not reasonably have relied upon such advice.

12. At all relevant times the defendants have operated their business in accordance with regulations and rules of registered exchanges having the force of law by reason of approval by the Securities and Exchange Commission.

13. Neither the Fund nor the Adviser was eligible to be a member of the NASD or the New York Stock Exchange or any other national exchange.

14. At all relevant times defendants and all directors have complied in all respects with the provisions of the Investment Company Act of 1940, including specifically, Section 10(d), both before and after its amendment in 1970.

15. Plaintiffs have an insuperable burden of proof in that any claim, even as to liability alone and without regard to quantum of damage, must be predicated upon hypothetical profits of a non-existent brokerage entity, and plaintiffs necessarily have no evidence and cannot create evidence to show the conjectural profits of a non-existent entity. The proof of at least some profit to a non-existent entity is essential to proof of liability or fact of damage. Moreover, as a second element plaintiffs must show that defendants personally profited by an amount of hypothetical profits of a non-existent entity. During the last several years almost all brokers have lost money, even on volume many times that of the Fund's brokerage business. Plaintiffs must also show as a third element injury to the Fund in some amount, which is impossible since the Fund received the value of brokerage services at the required rate.

16. Plaintiffs have the entire burden of proof and no part of the burden of proof or burden of going forward can be imposed upon defendants under general principles of law and under the Investment Company Act of 1940, including Sections 17 and 36(b) thereof.

17. Plaintiffs' case has mutated from purported "securities laws" claims to "corporate opportunity" which in reality would have been "corporate disaster" permeated with conflicts -- all of which the SEC and Congressional Committees would now expressly preclude.

4. Plaintiffs' exhibits.

1. Deposition of defendant Warren K. Greene taken on May 8, 1973.

2. Deposition of George A. Chestnutt, Jr. taken on May 14, 1973.

3. Deposition of Stanley Law Sabel taken on June 8, 1973 and marked exhibits numbers 13 and 14 marked at that deposition.

4. Deposition of Lloyd J. Derrickson taken on May 16, 1973.

5. Deposition of Thomas P. Phelan taken on May 24, 1973 and marked exhibits numbers 1, 2, 3 marked at that deposition.

6. Deposition of Arnold J. Currier taken January 24 and February 2, 1973.

7. Defendants Chestnutt, et al.'s answers to plaintiffs' interrogatories, second series.

8. Prospectuses and Proxies of American Investors Fund:

(a) Proxies for the years 1963 through 1973.

(b) Prospectuses for the years 1963 through 1973.

9. Prospectus of Investors Variable Payment Fund, Inc. dated March 12, 1973.

10. Prospectus of Investors Stock Fund, Inc. dated February 7, 1973.

11. Prospectus of Investors Mutual, Inc. dated December 22 1972..

12. Prospectus of Dreyfus Fund, Inc. dated April 30, 1973.

13. Prospectus of the Enterprise Fund dated April 30, 1968.

14. PBWSE Institutional member list dated March 5, 1973.

15. Newspaper Articles on Recapture:

(a) New York Times, Tuesday, January 5, 1965, first page of financial section.

(b) New York Times, January 9, 1965, pp. 29 and 33.

(c) New York Times, January 12, 1965, pp. 47 and 52.

(d) New York Times, February 19, 1965, pp. 47 and 49.

(e) New York Times, May 4, 1965, p. 50.

(f) New York Times, May 13, 1965, pp. 51 and 52.

(g) Wall Street Journal, May 27, 1965, p. 52.

(h) Wall Street Journal, June 30, 1965, article entitled: "Pacific Coast Exchange Amends Rules to Make IDS Eligible For Seat."

(i) Wall Street Journal, July 6, 1965, p. 4.

(j) Wall Street Journal, July 24, 1968, article entitled: "Fidelity Management Explains Plan Used to Channel Give-ups."

(k) Wall Street Journal, July 23, 1968, article entitled: "End of Give-ups Tied to Volume Discounts, SEC Hearing Is Told."

(l) Wall Street Journal, July 25, 1968 article entitled: "Regional Board Says Fund Manager's Unit Could Join Exchange."

16. SEC Release No. 8239 dated January 26, 1968 (commonly referred to as the SEC's 10b-10 release) which appeared at 33 Federal Register No. 21, Jan. 31, 1968 pp. 2393-2397 F.R. Doc. 68-1153 filed January 30, 1968.

17. Report of Committee on Interstate and Foreign Commerce on the "Public Policy Implications of Investment Company Growth" dated December 2, 1966.

18. Report of Special Study of Securities Markets of the Securities and Exchange Commission, Part 2, H. Doc. No. 95, Part 2, 88th Cong. Session, 1963.

19. Pacific Coast Stock Exchange Constitution and Rules.

20. List of approved non-members of the Pacific Coast Stock Exchange.

21. Philadelphia-Baltimore-Washington Stock Exchange Guide.

22. List of members of Philadelphia-Baltimore-Washington Stock Exchange. (PBW Stock Exchange Directory dated June 1, 1973.)

23. PBW Stock Exchange, Inc. securities traded January 1973.

24. Deposition of Elkins Wetherill taken October 24, 1968.

25. Letter from William Brodwater, vice president of the PBW Exchange to John Cannon dated December 14, 1967.

26. Manual of the National Association of Securities Dealers.

27. NASD notice to members 73-42, dated May 24, 1973 (anti-reciprocal rule declared effective).

28. Prospectus of United Funds dated April 28, 1967.

29. Prospectus of Channing Growth Fund dated April 1, 1967.

30. Prospectus of Investors Mutual, Inc. dated January 5, 1966.

31. Prospectus of Investors Mutual dated January 3, 1968.

32. Proxy Statement of Winfield Growth Fund, Inc. dated December 10, 1968.

Plaintiffs reserve the right to introduce additional exhibits in rebuttal.

Defendants' Exhibits.

1. N.Y.S.E. Constitution and Rules.

2. March 2, 1967 and reply of March 30, 1967

between Fund and N.A.S.D.

3. N.A.S.D. form of application for membership.

4. November 28, 1972 Statement of J. Walter Sherman before S.E.C.

5. "Williams" report of February 1973 of Senate Subcommittee.

6. "Moss" report of August 1972 of House Subcommittee.

7. Lists of defunct brokerage firms as compiled by Institutional Investor in July, August, September 1973 issues.

8. S.E.C. release No. 8746 (1934 Act).

9. S.E.C. "Future Structure of Securities Markets" release.

10. S.E.C. Ruling requiring 80% of brokerage of exchange member firms to be with public customers, presently the subject of litigation by Philadelphia Exchange.

Note: Since plaintiffs have proposed to introduce many exhibits (including prospectuses of no less than 10 other funds) which have never been shown to defendants, defendants reserve the right to introduce any S.E.C. releases or other evidence relating to market practices of investment companies.

11. Tabulations of data from Fund prospectus and proxy statements designated by plaintiffs as exhibits, which tabulations are in course of preparation.

12. File of newspaper clippings, copies of which

are being reproduced for plaintiffs and for Court.

Defendants reserve the right to adduce additional exhibits if deemed advisable.

5. Plaintiffs intend to call the following witness for direct testimony:

(a) Elkins Wetherill.

Plaintiffs reserve the right to call additional witnesses for rebuttal testimony.

Defendants' Prospective Witnesses

George A. Chestnutt

Warren Greene

Frank Fowler

Richard Radcliffe

John Currier

Stanley Sabel

William F. May	- Former director
J. Walter Sherman	- Sherman Deane Fund and N.Y.S.E. member
Robert Driscoll	- Former N.A.S.D. Governor
Peter Mumbach	- Fund Treasurer
Barbara De Gaetani	- Fund Assistant Treasurer and Treasurer Chestnutt Corporation

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By William F. Koegel.
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American Investors, Inc.
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SO ORDERED:

Inzer B. Wyatt
U.S.D.J.

September 4, 1973

Trial Transcript as corrected by order of Wyatt, J.

dated December 4, 1972.

investment fund, you could not then become a New York Stock Exchange member. It's a most astonishing rule, but that's the way --

THE COURT: The plaintiff doesn't rely on New York Stock Exchange transactions. We made that clear. These are regional stock exchange transactions that are the subject of this lawsuit.

MR. LEE: That is correct. I simply wanted to make our position clear on that.

Now, I think there is a slight misapprehension as to brokerage. We must pay brokerage. There is no way to avoid it. Now, during the period of time I mentioned that $650,000,000 worth of fund shares had been sold, there were redemptions of fund shares in that ten-year period which amount to some $363,000,000. Now, at the time Mrs. Fogel and her husband bought the fund shares in 1963, this fund only had some 6.6 million dollars in assets. Since that time there have been this $360,000,000 in redemptions. The fund must constantly be selling to take care of redemptions. The managers believe it is advantageous for new money to be coming in, advantageous to the shareholders and, of course, it benefits the advisor. The advisor goes into the business for the whole and sole purpose of having his fund grow, which will increase his

advisory fee. That's what he goes into business for.

I should -- then I will sit down and just cover very briefly a few high points here -- say that presently the SEC has taken the position that they don't want institutional investors and brokers to be tied in except in a very limited way and their proposal is that as long as a broker does 80 per cent of his business with the public, then it may do 20 per cent of its business with an affiliated advisor.

Quite recently, both houses of Congress, in their respective commerce committees, have presented proposed legislation which would completely prevent a brokerage firm from dealing with an in-house institutional investor. Now, what this boils down to, this case, as I view it, was a shotgun attack which now pretty much boils down to this: Were the outside directors ill advised by counsel?

Now, counsel have consistently recommended against getting into the duality of interest and the conflict of interest involved in going into the brokerage business in any way, shape or form. That's been adhered to. All the directors, when they became directors, knew this was a no-load fund. None of the directors ever recommended that it go into the brokerage business. When

like to call him with particular reference to the second point, and that is recapture.

Mr. Elkins Wetherill.

E L K I N S W E T H E R I L L, called as a witness by the plaintiffs, being first duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. MEYER:

Q Mr. Wetherill, what is your occupation?

A I am presently president of the PBW Stock Exchange.

Q When did you first become president?

A In May of 1965.

Q Prior to that time did you serve on the Pennsylvania Securities Commission?

A Yes, I was a practicing lawyer and I served on the Pennsylvania Securities Commission under Governor Scranton.

Q In what capacity did you serve on the Pennsylvania Securities Commission?

A Chairman.

Q The PBW Exchange was formerly known as the Philadelphia-Baltimore-Washington Stock Exchange, is that correct?

A That's correct.

Q When was the name changed?

xxx

A The name was changed in 1973, I think.

Q And were there any other changes made in connection with the name change?

A It became incorporated from an association to a corporation.

Q Apart from that, did the changeover affect any other practices or policies of the exchange?

A I don't believe at that particular time. We are constantly changing our rules, but I don't believe at the time we incorporated we made any changes.

Q As president of the exchange, is it your responsibility to enforce the constitution and rules of the exchange?

A Yes, it is.

Q And are you familiar with the constitution and rules of the exchange?

A Yes.

MR. MEYER: I would like to have marked for identification a document of six pages which is an excerpt from the PBW Stock Exchange constitution entitled Article XX -- that is Roman numeral twenty -- Commissions.

(Plaintiffs' Exhibit No. 1 marked for identification.)

MR. LEE: Your Honor, at this point in the record, may I simply note my objection to the testimony by this

witness. It is wholly irrelevant to the proceeding and incompetent to prove any issue. So that I wouldn't have to be cluttering the record with many objections.

THE COURT: All right, I will take it. Objection is overruled.

Q Mr. Wetherill, I show you Plaintiffs' Exhibit 1 marked for identification and ask you whether that was the provision -- whether that was Article XX of the constitution of the exchange as it existed prior to the abolition of give-ups on December 5, 1968.

A Yes, I think this was Article XX as it existed prior to the abolition of give-ups.

MR. MEYER: I offer it in evidence.

THE COURT: Mr. Lee has an objection. The objection is overruled.

Mark it, Mr. Clerk.

(Plaintiffs' Exhibit No. 1 for identification received in evidence.)

THE COURT: How were give-ups abolished?

MR. MEYER: I think Mr. Wetherill can testify --

Q Well, why don't you answer the question?

THE WITNESS: The SEC, your Honor, wrote to all of the exchanges in November or October of 1968 and said that as of some day in December, which I can't recall, 1968,

the practice would -- I can't remember the exact wording they used, but that they didn't want the practice to continue after that particular date.

Q And the exchange adopted the rules?

A And the exchange adopted rules pursuant to this request of the SEC.

Q Mr. Wetherill, I direct your attention to that portion of Page 3 of Plaintiffs' Exhibit 1 -- I have another copy here -- which reads as follows:

The heading says "Investment Fund Orders." The first paragraph says: "Members and member organizations may accept orders for execution on the exchange from investment funds registered under the Investment Company Act of 1940 on a give-up basis to include other members subject to the following conditions."

And then I skip down to No. 3 and it says:

"Give-ups for nonmember. If the order is designated as one to be executed on a give-up basis for nonmembers who are members of the National Association of Securities Dealers, the executing member may credit not to exceed 40 per cent of the commission earned to a special account to be identified in the member's records as 'nonmember's investment fund give-up account.'"

When was that provision first adopted?

A If I could refer to some notes that I have here. This is a customer-directed nonmember give-up, is what we called it, and on May 7th of 1964, we started customer-directed give-ups, but at that time they had to be to members only. Then, on November 9, 1965, we brought in the nonmember aspect, and the give-up could total 65 per cent but the nonmember could get no more than 25 per cent. And that practice continued until December 5, 1968, when we adopted the rules requested by the SEC.

Q Excuse me. At some point, the 25 per cent was raised to 40 per cent, was it not?

A The 25 per cent was raised to 40 per cent, that's right.

Q And when was that?

A I just don't know exactly when that took place.

Q Directing your attention to Page 3 of the exhibit, Exhibit 1, at the bottom, do the dates there refresh your recollection?

A From looking at the date that this was amended, I would say that the 40 per cent came into effect on June 15, 1966.

Q Thank you.

Now, pursuant to that provision of the constitution, was it permissible, prior to December 5, 1968, when give-ups

were abolished, was it permissible for give-ups on commissions on transactions from mutual funds executed on the PBW Exchange to be paid to members of the NASD who were not members of the Exchange?

A Yes, that's correct.

Q So that if an order originated from a mutual fund, 40 per cent of the commission could be given to an NASD member, at least from November '65 to June '66, it was 25 per cent and from June '66 for two and a half years until December 1968, 40 per cent; is that correct?

A That's correct.

Q That could go to an NASD member only?

A Right.

Q Now, if an NASD member who received such a give-up were an investment advisor of the mutual fund whose transaction was executed, would it be permissible under the constitution and rules of the exchange for such investment advisor to credit the amount of the give-up against the advisory fee owed it by the fund?

A Yes, it would.

Q Now, if the NASD member who received the give-up were instead of the advisor a subsidiary of the advisor, would the advisor be permitted to make such a credit?

A If the NASD member was a subsidiary of the

advisor?

Q Yes, would the advisor be permitted to credit the advisory fees of the fund with the amount of the give-ups?

A There is nothing in our rules that says one way or the other what would happen to that. Our guidelines always were that if there was some contractual relationship, then there would be no reason why these profits couldn't be passed back.

Q Now, with respect to the ability of the investment advisor to credit the advisory fees of the fund with the amount of give-ups received by it or its subsidiary, which you have just testified to, would your answer be any different if the fund were a no-load fund?

A No, it would be no different.

Q Now, apart from the investment advisor being a member of the NASD or forming a subsidiary to join the NASD, if the fund itself formed a subsidiary which became a member of the NASD, would it have been permissible under the rules of your exchange for the give-up to have been paid to that entity?

A Yes, as long as it was a broker-dealer registered with the NASD.

Q And if such a give-up were paid, would it be permissible under the constitution and rules of the exchange for the NASD member to pass the give-up to the

parent fund in the form of a dividend?

A Yes, with the same qualifications that I made before, that our rules said nothing about what happens to the profit of these broker-dealer subsidiaries and our guidelines say that as long as there was either a contractual relationship or they were passed back by means of dividends that we would find no objection to that.

Q Again, I take it, it would make no difference whether the fund were a load fund or a no-load fund without an underwriter?

A No difference.

Q Mr. Wetherill, I am going to turn now to the question of exchange membership and all my questions as to the availability of such membership relate to the period from when you became president of the exchange in 1965 up to January 1973, when the SEC adopted Rule 19b-2.

Now, during that period, in order to qualify for membership on the exchange, a corporation's principal purpose must be the transaction of business as a broker or dealer in securities, is that correct?

A That's correct.

Q And that is pursuant to Article XIV, Section 2 of the constitution, is that correct?

A I don't know offhand what the provision is.

Q I am sorry. I don't have that with me.

In any event, that is your understanding?

A That's correct.

MR. LEE: Would you repeat the reference, Mr. Meyer?

MR. MEYER: Article XIV, Section 2.

Q Now, in order for a corporation to be deemed to have its principal corporate purpose as the transaction of business as a broker or dealer in securities, is it necessary for the corporation to actually execute the transactions?

A It is not necessary for the corporation to actually execute transactions, no, that is correct, but I think that the answer requires some amplification. Obviously it executes transactions in some way even though it doesn't do them itself. The corporation would not be a broker-dealer in securities if it couldn't execute buy and sell orders for customers even if the customer was its parent.

Q I am talking now about the mechanical execution. It needn't be on the floor of the exchange and execute?

A No, it need not.

Q Would it be necessary for the corporation, in order to qualify, to clear the transaction?

A Itself, no.

Q Would it be sufficient for the corporation to qualify as a broker or dealer if it acted as an introducing broker and transmitted brokerage orders to other members of the exchange for execution and clearance?

A There would be no objection to that.

Q Would the corporation be disqualified from membership if it were the subsidiary of an investment advisor of a mutual fund?

A No.

Q Would your answer to that question be any different if the mutual fund were a no-load fund?

A No different.

Q Would the corporation be disqualified from membership if it was a subsidiary of the fund itself rather than the advisor?

A No, it wouldn't.

Q Would your answer be any different if the fund were a no-load fund?

A No, my answer would be the same.

Q Now, in determining whether a corporation's principal purpose is that of a broker or dealer, do you consider the corporation's business together with the business of its parent or other affiliates?

A Not necessarily, no. The individual who is applying

for membership and who is an officer of the corporation appears before our membership committee, and usually we require that he bring with him schematic diagrams of the whole corporate setup of the entities involved so that the admissions committee has some background as to exactly who this member is that they are considering. But we are primarily looking at the member himself and the organization in which he is an officer. We reserve the right to inspect the books of any parent or to suspend from membership the member if the parent should become involved in practices which we think are not in the best interests of the exchange.

Q But you are primarily concerned with the corporate applicant itself rather than the parent?

A Exactly.

Q And in this respect do you differ from the New York Stock Exchange?

A Yes, right.

Q The New York Stock Exchange --

A -- has a parent rule which says that the parent must also be primarily in the brokerage business.

Q And you do not?

A No, we do not.

Q Now, coming back to the corporation applying for

membership during the period that I specified, would it have been necessary for such a corporation to have been a member of the NASD?

A Yes.

Q Are all the member corporations members of the NASD?

A I am positive that they are. I can check with our general counsel after we adjourn and if that is not correct I can let you know, but, to the best of my knowledge, all our institutional members are members of the NASD.

Q Is it required that a member corporation have more than one customer?

A No.

Q Is there any requirement that a member deal with the general public?

A No. I would like to qualify that because many times, in testifying in Congress, we have taken the position that a broker-dealer who is an affiliate of a mutual fund or an insurance company is, in effect, dealing with the public because he is transacting business for the thousands of shareholders in the mutual fund or policy holders of a mutual company. That is, in effect, doing a public business. We get into that argument of the 80-20 business, what is a public business. We claim that these

brokers do do a public business.

MR. LEE: If the Court please,I wonder, is there some exhibit before the witness? Is he testifying as to the actual rules?

MR. MEYER: No, there is no exhibit before him. I don't know if he has a copy of Plaintiffs' Exhibit 1.

MR. LEE: I am somewhat bewildered as to whether we are discussing the actual rules.

MR. MEYER: He stated that he is familiar with them.

MR. LEE: And the questions deal not with the specific rule?

MR. MEYER: The discussion has been oriented to Article XIV, Section 2, the rule that requires a member to be a broker-dealer, and I am trying to find out what that means.

MR. LEE: Wouldn't the best evidence of that be the actual rule?

THE COURT: Let's go on and ask another question, Mr. Meyer.

Q Mr. Wetherill, do you have any member firms which are affiliates of instutions?

A Yes, we do.

MR. MEYER: I would like to have marked for

identification a list dated March 5, 1973, entitled "PSWSE Institutional Member List."

xxx (Plaintiffs' Exhibit No. 2 marked for identification.)

Q Now, Mr. Wetherill, I show you Plaintiffs' Exhibit 2 for identification and ask you whether this is a list prepared by the exchange of institutionally affiliated members as of March 5, 1973.

A Yes, it is.

MR. MEYER: I offer it.

THE COURT: Any objection?

MR. LEE: Same objection.

THE COURT: Same ruling.

Mark it, Mr. Clark.

xxx (Plaintiffs' Exhibit No. 2 for identification received in evidence.)

Q Mr. Wetherill, is it your understanding that most of the institutional affiliates listed on this list, Plaintiffs' Exhibit 2, obtained membership for the purpose of recapturing brokerage commissions?

A Yes, I think that's a fair statement.

Q Mr. Wetherill, as far as you are aware, has any institutional member of the exchange ever had any capital problems?

A No.

Q If the member corporation acted as an introducing broker and did not execute or clear its own transactions, what percentage of the commission would it ordinarily retain?

A I think it depends on the arrangement that can be worked out, but it's somewheres in the neighborhood of 80 per cent would be retained.

THE COURT: Tell me, is the member of your exchange an individual or a corporation?

THE WITNESS: The member himself, your Honor, is an individual, but then we admit the member corporation of which he must be an officer, but the seat, as we call it, is actually held by an individual.

THE COURT: Is the corporation with which he is connected, is it a member also?

THE WITNESS: It is called a member organization.

THE COURT: A member organization.

THE WITNESS: But the member who has the right to vote in the anl al elections and that kind of right is an individual.

THE COURT: All right.

Q Is it possible, Mr. Wetherill, for PBW members and member organizations to obtain reciprocal brokerage on PBW from New York Stock Exchange members?

A Yes, it is possible.

Q And I take it this is done, is that correct?

A It is done.

Q So that if a member placed most of its business on the New York Stock Exchange, it could nevertheless receive substantial benefits from that brokerage in the form of reciprocal brokerage from dual members of New York and Philadelphia?

A Yes, that's correct. I don't know exactly what you mean by "substantial," but it could receive.

Q And the brokerage would depend on the particular arrangements that they could work out?

A Yes.

Q What was the price of a seat on the exchange prior to the promulgation of Rule 19b-2 in January 1973?

A About $10,000.

Q And how many stocks are traded on your exchange?

A About twelve hundred.

Q Are most of these stocks also listed on the New York Stock Exchange and American Stock Exchange?

A Yes, roughly eight hundred of that twelve hundred would be listed on the New York Stock Exchange and I would say two or three hundred on Amex, and the rest are solely listed on our exchange.

Q Are the dually listed stocks, are most of them stocks in which institutions are interested in trading?

A That's a difficult question for me to answer. Let me say and answer it this way, that those eight hundred New York Stock Exchange stocks are all of the active stocks that are traded on the New York Stock Exchange. There may be institutions that are interested in some inactive stock that is not in that eight hundred list, but it would be hard for me to say.

Q What was the total volume of sales on the exchange in 1972?

A Slightly in excess of 145,000,000 shares.

Q Mr. Wetherill, are any of your members subsidiaries of investment advisors of mutual funds?

A Yes, they are.

Q And are any of your members subsidiaries of investment advisors of no-load mutual funds?

A I believe that -- one I know of. I don't know how many more. This is not a question that our admissions committee asks, as to whether the fund is load or no-load, and really I am not that aware of it. I happen to be aware that one of our members is advisor to a no-load fund.

Q Where a subsidiary of an investment advisor of

a mutual fund is a member of the exchange, is it permissible under the constitution and rules of the exchange for the investment advisor to credit against the advisory fees of the fund profits received by the subsidiary?

A Yes.

Q Would your answer be any different if the fund in that question were a no-load fund?

A No.

Q Now, where the member is a subsidiary not of the investment advisor but of the mutual fund itself, would it be permissible under the constitution and rules of the exchange for that subsidiary to pass its profits to its parent mutual fund in the form of a dividend?

A Yes, it would.

Q And would your answer to that question be any different if the fund were a no-load fund?

A No.

Q Today, are firms which joined the exchange prior to the adoption of Rule 19b-2 still permitted to recapture commissions?

A Yes, subject to an order of the District Court, Eastern District of Pennsylvania, there is a stay on the implementation of Rule 19b-2 pending the outcome of litigation between ourselves and the SEC.

THE COURT: Mr. Meyer, what is this rule to which you refer from time to time? Rule 19b something or other.

MR. MEYER: Rule 19b-2 is a rule recently adopted in January 1973 by the Securities and Exchange Commission which contains a number of complicated provisions, but essentially would require members of exchanges to do 80 per cent of their business with the public.

Q Is that correct, Mr. Wetherill?

A It is a rule of the Securities and Exchange Commission requiring all of the registered security exchanges in the country to adopt rules which would comply with these various requests.

Q I see. And your exchange is presently litigating the validity of that request?

A That is right. We sued the SEC in the Federal District Court, Eastern District of Pennsylvania, and we are joined by the Department of Justice as amicus and four or five of our members, institutional members, joined with us, and also the State of Connecticut.

Q And you have obtained a stay of that rule?

A Yes, a stay. That means, in effect, we do not have to adopt any rules in compliance with 19b-2 and our institutional members can continue to do business with us.

Q So I take it your present institutional members are not required to do a public business, is that correct?

A That's correct.

Q I want to ask you a hypothetical question, Mr. Wetherill, which is rather complex, so I warn you to listen carefully and if you have any difficulty with it I would be glad to reread it to you or have the reporter read it back.

If a no-load mutual fund was effecting portfolio transactions which generated commissions in excess of $2,000,000 per year, and if that fund or the investment advisor of that fund formed a subsidiary which employed as officers a person or persons who had experience in placing orders for fund transactions, and if one of such employees had had prior experience with a securities firm known as First Boston Corporation and had passed the NASD exam for registered representative, and it was stated that it was the intention that said subsidiary would continue to place orders for portfolio transactions of the fund as an introducing broker with other brokers and dealers, maintaining appropriate bookkeeping records, and if it were further stated that the fund was the only customer of the subsidiary and the purpose of exchange membership was to recapture brokerage commissions, would, in your

opinion, such subsidiary have been eligible for membership on the PBW Exchange prior to the adoption of Rule 19b-2 earlier this year?

MR. LEE: Objection.

THE COURT: I will take it. Overruled.

A There are two other criteria that you didn't mention before this firm would have been eligible, and one is that it meets our capital requirements, and the other is that it is a member of the NASD.

Q What are your -- can you briefly state your capital requirements?

A The capital requirements, they were recently changed and now for an entering firm it must have $45,000.

Q And subject to those two qualifications, the answer would be that they would be admitted to membership?

A Yes.

Q Mr. Wetherill, did you participate in the SEC hearings in 1968 concerning commission rates and give-ups?

A Yes, I did.

Q Those hearings occurred in large part in connection with the proposed Rule 10b-10 of the SEC, did they not?

A I think the proposed 10b-10 came out of those hearings. Whether the hearings were specifically -- I don't remember that 10b-10 was the subject of the hearings,

but it came out of them.

MR. LEE: Excuse me. I didn't hear the date. Did you say March of 1968?

MR. MEYER: I just said 1968.

Q Do you recall what the proposed Rule 10b-10 would have provided?

MR. LEE: I object, your Honor, to his being asked what a proposed rule of the SEC would have provided.

THE COURT: He can answer.

A I can't answer it.

MR. MEYER: May I ask that the Clerk mark for identification a document entitled "Securities and Exchange Commission, Securities Exchange Act of 1934, Release No. 8239"?

(Plaintiffs' Exhibit No. 3 marked for identification.)

Q Mr. Wetherill, I hand you Plaintiffs' 3 marked for identification and ask you whether you have ever seen that before.

A Well, I don't recall. The SEC puts out many releases. I must have seen it, but I just don't know. If you give me a chance to take a look here. I have just forgotten what 10b-10 was all about over the years.

Q That is why I wanted you to look at it. I want

to refresh your memory.

Let me direct your attention in particular to the last two pages of the release.

Do you recall the rule now?

A I recall the rule.

Q And what would the rule have provided?

A The rule in effect was leading up to the abolition of the give-up.

Q Do you recall that after the abolition of the give-up the SEC withdrew the proposed rule?

A Yes, they did.

Q Apart from the hearings, did you have in 1968 and 1969 discussions with the SEC staff on the subject of give-ups?

A Yes, many times.

Q And as a result of your discussions, did you form an understanding as to the reason for the withdrawal of the proposed rule?

MR. LEE: I object.

THE COURT: Well, I must say I think the objection is well taken but if we can get an answer, we should.

Can you answer it?

THE WITNESS: No, your Honor, not really. I can't recall.

Q Were you told that the rule was withdrawn because since the exchanges acquiesced in abolishing give-ups it was no longer necessary for the SEC to promulgate a rule?

A That was the effect. If all of the exchanges adopted rules that would abolish give-ups, then the SEC's proposed rule wouldn't be necessary. But how this all came about in these conversations, which is what I thought was the point of your question, I really can't remember. I have so many meetings and conversations with those people that I just can't recall.

MR. MEYER: I have no further questions.

THE COURT: Any questions, Mr. Lee?

MR. LEE: Yes, your Honor.

CROSS-EXAMINATION

BY MR. LEE:

Q Mr. Wetherill, I thought I heard you say that a member firm could be an introducing broker and that, in any event, however the broker is described, he would either be dealing for his own account or for others; is that correct?

A I think that is correct, yes.

Q So that if a subsidiary of an investment advisor were a member of your exchange, in the event that he were

dealing for the fund which his advisor advised and executing transactions for that fund, he would in effect be self-dealing, would he not, dealing for a captive account, in effect?

A He would be dealing for one account.

Q But an account with which it was affiliated, isn't that correct?

A Yes.

Q Or in the alternative --

A I wouldn't characterize that. When you call that self-dealing, I didn't quite -- that had the hint of doing something wrong.

Q Well, it is dealing with one's self, is it not?

A I think it's dealing with one's parent. The firm would have been established for the sole purpose in most cases of these fifty institutional members that we have of handling one account.

Q Correct. But it does involve dealings which I will call self-dealing which you prefer to call something else, or in the alternative a broker member of your exchange could be dealing with the public in general?

A Yes.

Q And I further understand you to say membership in the NASD was a prerequisite to membership in your exchange?

A Yes, I am almost positive of that. As I say, I will have to check with our counsel on that, but I am almost positive that is a requirement.

MR. LEE: No further questions, your Honor.

THE COURT: Mr. Meyer, anything else?

MR. MEYER: Your Honor, I would like Mr. Wetherill to consult his counsel on this question of NASD membership. I think it's important. In fact, I know his counsel is here. If necessary, I would like to call his counsel on that point.

THE COURT: Can it be cleared up? The whole thing is membership in NASD a condition of membership in this exchange?

MR. MEYER: That is correct.

THE COURT: Mr. Wetherill, do you suppose you and counsel could get together?

THE WITNESS: Yes, sir, immediately we could.

(Pause.)

REDIRECT EXAMINATION

BY MR. MEYER:

Q Mr. Wetherill, have you conferred with counsel on the question of whether it is necessary to be a member of the NASD in order to be a member of the exchange?

A Yes, I have. The answer is there is no requirement

that a firm be a member of the NASD member organization. However, most are because if they wanted, one, to get the customer-directed give-up they would have had to be a member of the NASD and, two, if they wanted to do any dealings over the counter or with the third market, they would have to be members of the NASD, and most of them do that. However, most of our members on the floor, the specialists on the floor and the floor brokers, are not members of the NASD.

Q And an institutional affiliate would not have to be a member of the NASD in order to join, is that correct?

A No, it would not.

Q And could nevertheless recapture commissions?

A That is correct, but could not have in the days of the give-up, could not have received the give-up as a nonmember.

Q But as a member, it could have joined and could still have recaptured commissions?

A Yes.

MR. MEYER: Thank you. I have no further questions.

THE COURT: Thank you, Mr. Wetherill, you may be excused.

(Witness excused.)

brokerage affiliate?

A Yes, I think there would be.

Q Would you describe some of those?

A At that point our traders would probably be transferred over and would be working for the brokerage affiliate because the function would be the same and their expenses would probably be charged to such an affiliate.

I believe they are in the case of others who have gone that route.

Q Have there ever been any fund portfolio transaction that you can recall where there was no broker involved?

A Yes, there have been.

Q Or dealer. Would you describe those?

A Well, occasionally we will find -- let us say we were looking to buy a security. Occasionally we will find someone who owns that security and we will deal directly with that person, whether that be a corporation or an individual, in which case we do not even go through a broker and there is no commission involved, for example, some stock from another mutual fund that way when we happened to remember, having seen the stock in its portfolio. So we simply called up the fund and said "Would you like to sell your stock" and they said "Yes" and we bought it from that. Actually, it was an over-the-counter security

and we did it at the mean between the bid and ask, right halfway between the two, and both of us were happy and no commission was paid.

Also, when we had a large block of stock to sell, on occasion we have sold the stock to the company itself.

Q Does any recent transaction such as that come to mind?

A We sold some Combustion Engineering worth about $10 million to the Combustion Engineering Corporation at the last sale on the New York Stock Exchange, and there was no commission involved at all.

Q Now, if you were to form a brokerage affiliate, amember of the NASD, and charged a commission, what effect would that have on the net proceeds to the fund?

A The fund would get less.

Q By the amount of commissions on a $10 million block?

A Actually in that case presumably our brokerage subsidiary would charge a commission on both sides of the transaction, would charge the company a commission and would charge the fund a commission and presumably a portion of the fund commission would be refunded to the fund but we could make some money on the other side and charge the company something, and in the process, though, the company would

me. They said it to Mr. Sabel. But he reported it to me.

Q I see.

And I think you testified that you never gave Jesup & Lamont more than 10 per cent of the funds brokerage?

A Incidentally, I will say this right now, that when we went out of the courtroom Mr. Lee corrected me on that and he said "I believe you are wrong on that, I think it was over 10 per cent."

Q How much over 10 per cent was it?

A Well, I don't know, but he told me that Jesup & Lamont had received the largest amount on more than one year and I was not fully aware of that, in which case it could have been like possibly 12 per cent or 15 per cent, I don't know how much, but I do know this, that in general no broker would ever go over about those figures.

Q You think it was possibly as high as 12 or 15 per cent?

A After discussing it with Mr. Lee, I would believe that it could be. I have nothing to substantiate it other than Mr. Lee's statement to me out in the hall that there were two or three years in which Jesup & Lamont had the largest amount.

Q Now, Mr. Chestnutt, I will show you Plaintiffs'

Exhibit 10 in evidence, prospectus of American Investors Fund dated March 10, 1967, and I am referring to page 11 here. Can you tell me what the total brokerage fees paid by American Investors Fund in 1964 were?

A $275,000.

Q And in 1964, out of that $275,000 how much was paid to Jesup & Lamont?

A It looks like $111,242.

Q Which is approximately what, about 30 per cent, almost 40 per cent?

A Yes, that would be of the order of 35 per cent.

Q Now, in 1965 what were the total brokerage commissions of the fund?

A 387,000.

Q And how much was paid to Jesup & Lamont?

A 137,000.

Q A little less than a third; is that correct?

A It looks that way, yes.

Q And in 1965 what were the total brokerage commissions of the fund?

A 551,668.

Q And how much was paid to Jesup & Lamont?

A You are talking about 1966, wasn't it?

Q 66, yes.

A I think you said '65.

Q You are right. I stand corrected.

A In '66 it was $125,989.

Q Out of 551,000?

A Yes.

Q Or about 20 to 25 per cent?

A Yes.

Q What was the ownership in percentage terms of Fund of Funds of American Investors?

A The highest that it ever reached, to my knowledge, was about $33 million and the total assets at the time were approximately $100 million. Therefore, they only had approximately a third at the exact peak of their ownership.

THE COURT: Did they buy their shares of the fund from the fund itself?

THE WITNESS: Yes.

THE COURT: And were there any give-ups in connection with that purchase?

THE WITNESS: No.

THE COURT: And how long did they have an interest -- three or four years?

THE WITNESS: I believe they made their first investment about 1964. It could have been late '63. I don't remember for sure. And I believe they got out in

1967. It seems like '67, anyway.

Q When they got out, did you continue to use Jesup & Lamont?

A Yes.

Q On the same scale as indicated here?

A No, I don't believe so.

Q And, in fact, when you did use them you then directed give-ups, is that correct, after Fund of Funds sold out?

A At some point along there we did direct give-ups, that is right. My recollection is that we didn't begin directing give-ups until quite a long while later.

Q So when you say that you did not favor any one broker for an extended period of time, that has to be qualified at least to the extent that these figures show the brokerage commissions received by Jesup & Lamont over three years?

A I would say that is correct, yes. I wasn't even thinking about Jesup & Lamont when I made the statement.

Q Mr. Lee read to you from Exhibit 4, the PPI report, at page 59 and he read you the sentence:

"And some no load funds encourage brokers to recommend their shares to prospective investors by directing their portfolio brokerage business to those brokers

I take it that when you said you learned about this from the SEC complaint, that was long after the payments of commissions by the fund?

THE WITNESS: That's true. I never heard of Gloria Martico Clapp until we were sued.

THE COURT: And certainly, at the time of the transactions, you didn't know anything about it?

THE WITNESS: I knew absolutely nothing about it. In fact, I have never laid eyes on her until this day. I have never seen her and I only know of her through having been sued about it.

THE COURT: I assumed that was the case. I just wanted the record to be clear.

Q Let's test that assumption.

When did you stop doing business with Jesup & Lamont on a large-scale basis?

A We never stopped doing business with them. We would give them an order tomorrow if we wanted to. We have never stopped.

Q On a large-scale basis, when did you stop?

A Mostly when Dave Dodles left there.

Q In the middle of '67, isn't that correct?

A No, no, I think later than that. It sort of trailed off. It didn't just stop, as you suggested. It

THE COURT: What do you say to the objection, Mr. Meyer?

MR. MEYER: The point of the question, your Honor, is this: Mr. Chestnutt has testified that the setting up of a brokerage operation would require a lot of new expenses.

The fact of the matter is the expenses already are in existence. There are traders, there is quotation machinery.

THE COURT: I will permit it. Overruled.

Q Would you like the question read back?

A You will have to because I don't remember what it was now.

(Question read.)

A Yes.

Q Now, you mentioned that you have traders. How many traders are there?

A Traders now or at any time in the past?

Q Well, let's start with now.

A I would classify as specifically traders Warren Greene does the most of it by far. I do the next largest amount, which might possibly be a quarter as much as he does or even less now. But we also have other people who -- for example, we have two girls on our trading desk who both of us delegate orders to, andthey place those. I think

of those as traders whenever they have been delegated a job to do.

And then we have other -- two particular people who are in our investment counseling subsidiary who both do that trading function whenever -- for example, if Warren and I were both going to be out of the office, we would designate one of those vice presidents of the counseling firm to do the trader's job. So in all there are currently roughly five traders but the big bulk of the work is done by Mr. Greene and the next largest amount by myself.

Q You have suggested that this might have differed over the years. Can you explain that?

A Well, in years gone by when our total personnel was higher and the volume of such trading was much higher the number of traders was accordingly greater.

Q And I assume that conversely when it was lower, it was also lower?

A I recall back in Larchmont when I did it all myself.

Q And you mentioned an incident involving the sale of some $10,000,000 worth of Combustion Engineering stock to the company itself and you said if you had placed that order through an NASD subsidiary and that you would have had to charge yourself commission.

sale? What did they come to?

A As far as we were concerned?

Q Yes.

A It is hard to say what our expenses were. There were a number of telephone calls, I would say I would have to allocate about perhaps half a day of Mr. Greene's salary and a certain portion of my own and a proportionate share of overhead applicable to any amount of time. I should say it probably cost Chestnutt Corporation on the order of fifty to a hundred dollars to perform that function: I might add in doing that we saved-- I am estimating. The commission would have been even with the negotiated commissions only excess would probably have been in the order of $25,000.

Q $25,000 of commissions to which would be attributable fifty to a hundred dollars of expense?

A Had we placed the order with any ordinary broker the commission would have amounted to something like that on a ten million dollar transaction. That's an estimate. Prior to negotiating commissions it would have been $80,000.

Q Mr. Chestnutt, you read the PPI when it first came out, did you not?

A Yes.

Q And at that time you read the portions of the PPI

it repeatedly in telling me to stay out of the brokerage business and stick to the thing I know best, which is analyzing the market.

Q If you form an affiliate that merely receives commissions and pays them back to the fund, where is the self-dealing?

A I didn't know that it was possible to do that and it never occurred to me until you brought it up.

Q Did you ever make any inquiry of the NASD or of the Philadelphia Exchange whether it was possible?

A NASD stands for National Association of Securities Dealers. That means that the members are securities dealers; not just holding out a place for a mail drop for checks to fall into. Itdidn't occur to me that it was a national association of check drop artists.

Q Doesn't it include brokers as well as dealers?

A Most brokers also belong to the NASD. They have to, yes.

Q And brokers place transactions, don't they?

A Yes.

Q And you testified that you had as many as six traders who would check markets, place orders and you had Nasdaq equipment and telequote equipment. You still don't think you would have qualified for NASD membership?

the price anyway. There have been times I put bids on more than one exchange simultaneously.

Q Mr. Greene, there has been furnished to the plaintiffs in this case, in response to interrogatories, some two or three thousand letters -- I am not sure how many it is but I thought in terms of 3,000 letters. Maybe that is accurate, maybe it isn't -- most of which were signed by you with respect to what we call give-ups.

Now, those give-ups were on various exchanges and I want to ask you whether, so far as you know, every single one of those letters written by you or written at your direction was in accordance with the rules then obtaining of whatever exchange the transaction referred to.

A I followed all the rules that I knew of in regard to give-ups. I might add that most of the time brokers volunteered to give up. They would come to us and say "If you do brokerage business with us, we would be happy to give up a portion of the commission."

Q And that is to encourage you to give them some actual executions, correct?

A That's right. And that was the industry practice at the time. Of course, we followed all the rules of the exchanges involved.

THE COURT: Did the rules of the exchange recognize

give-ups?

THE WITNESS: Yes, sir.

THE COURT: I suppose the only or at least a requirement was that the broker sharing the commission had to be members of the exchange?

THE WITNESS: That was true on the New York Stock Exchange. On the New York Stock Exchange we could ask one member firm to give up a portion of his commission to another member firm. So the members of the New York Stock Exchange collectively all kept their commissions. Now, the regional exchanges were different in that they would allow a give-up to be sent to a non-member of the exchange who would have to be an NASD member. I think the regionals did this for competitive reasons.

Q Mr. Greene, in connection with your duties at Chestnutt Corporation, have you ever assisted or -- assisted Mr. Chestnutt or actually written his weekly report from time to time?

A I have assisted on numerous occasions in that we would discuss general economic events, the current state of the market, et cetera, and I always give my opinion when called for and sometimes when not. I have written a report myself in George's absence and stand ready to do so at any time that he is either on vacation or otherwise disposed.

Q Mr. Greene, there has been some mention here by Mr. Meyer of tender offers and moneys payable in connection with tender offers.

Do you happen to recall during the time that you have been at Chestnutt Corporation any occasions that you can identify where American Investors Fund tendered stock pursuant to a tender offer and the fee mentioned in the tender offer was then paid to a broker or dealer?

A Yes, there have been occasions that we have tendered stock.

Q Can you identify those?

A I can't identify them.

Q Do you have any idea of the magnitude of any such?

A It was the kind of thing that happened very rarely that we have a stock in the portfolio in which a tender offer would be made. It happened from time to time, maybe one a year, or something of that nature, but it was nothing that happened day to day.

Q Do you have any idea of the magnitude of any of such holdings?

A I don't really have an idea, although we have had some -- it could be anywhere from a few thousand to fifty thousand shares, because that was the size of our position. It would have to be somewhere in there.

THE COURT: Mr. Lee, these 3,000 letters to which you referred, I don't believe they are in evidence, are they?

MR. LEE: No, sir, they are not. I hope they won't be introduced.

MR. MEYER: I am sure you don't want them.

MR. LEE: Your Honor, at this point I am thinking in terms of your Honor's schedule tomorrow and the problems in connection with further witnesses. As I understand it, you are going to the Judicial Conference on Friday.

THE COURT: No, I leave tomorrow. We stop at noon tomorrow. We won't resume until at least Monday. I will have to look at my diary.

MR. LEE: I was wondering this because Mr. May, who is a former director and who is not a defendant, is presently in Denver in connection with a directors' meeting of Johns Manville. He is chairman of the board of American Can. I would hope to be able to have him and Mr. Radcliffe and Mr. Currier next week perhaps. I doubt if I could get through with Mr. Greene today and tomorrow. I simply don't know and I don't know the extent to which Mr. Meyer will want to cross-examine. But it is now -- we have another 15 minutes or so to go. I would like to be able to telephone these people as best I can and try to arrange it.

THE COURT: Would you go up and bring down my diary,

please, and we will settle it before I leave.

MR. LEE: Thank you, sir.

THE COURT: I don't imagine Mr. Meyer would object to your interrupting the witness' testimony.

MR. MEYER: Not at all.

BY MR. LEE:

Q Mr. Greene, are you familiar with Plaintiffs' Exhibit 4, which is PPI, public policy implications of investment company growth?

A I have read it.

Q Has that been a subject of discussion between you, Mr. Chestnutt and Mr. Sabel?

A We have discussed portions of it.

Q Have you ever discussed portions of it or discussed its existence with any of the other members of the board?

A Could you give me some definite area?

Q I'd like particularly to mention Mr. Radcliffe.

A I don't recall having any private discussions with Mr. Radcliffe. I think we have discussed portions of the document in board meetings at which Mr Radcliffe was present and we probably all participated in the conversation. This is the kind of thing that Mr. Sabel used to bring up to board meetings so we would be informed.

Q Turning specifically, Mr. Greene, to the manner in

which you effect brokerage transactions for the fund, what do you do in considering the question of price or third market execution or possible execution on a regional exchange? Would you describe for the court your processes in analyzing that?

A Well, the first thing is to know what kind of security it is or the type of trading security.

Q We will make an assumption as to a particular type of security and describe it, please.

A Let's take a security such as General Motors. General Motors is known to trade in the third market as well as on the New York Stock Exchange. There is fairly substantial volume in both areas. A primary third market house trading General Motors is Weeden & Company, and Weeden may make from time to time a large market in it. They may be willing to buy 10,000 shares at 65 and sell 10,000 shares at 65-1/4. The last sale on the New York Stock Exchange might be 65-1/8. They are competing directly with the New York Stock Exchange.

Q By "competing," are they competing as brokers or are they taking a risk themselves?

A They are taking a market risk, they are willing to buy 10,000 at 65 or sell 10,000 at 65-1/4. Not always, but that is the scope of the market in General Motors.

Q If they sell to you, are they short the stock?

A They may short or they may sell it out of their long account. They don't tell us what they are doing and it is none of our business. They do what they wish to do. They may be just as happy to go short as long or sell long stock as go short.

We also know there is a good active market on the New York Stock Exchange. In a stock like this it is my custom to make a phone call to Weeden perhaps even before I put a bid in on the exchange and ask them what they are doing in General Motors and what their market is.

Q Even before that, can't you punch out on your machine and get the bid and ask?

A I can punch out my machine and get the last sale on the New York Stock Exchange, but the New York Stock Exchange has a rule against letting a non-member have the bid and ask. So we are deprived of that.

Q So you have to telephone a member firm to get the bid and ask, is that correct?

A Yes. Now, I may decide to, under the circumstances, depending what the market conditions are and what the quote and size of the market is on the floor of the New York Stock Exchange, I might decide I am better off buying General Motors from Weeden at 65-1/4. I may at the same time put a bid on the New York Stock Exchange for stock which would get me

stock cheaper than 65-1/4 net. Almost all trades with Weeden are on a net basis. So what I would be trying to do in buying General Motors would be trying to get a better price from Weeden, which is, as I say, independent of the stock exchange than I could on the New York Stock Exchange. But I would at times -- I would often put a bid on the New York Stock Exchange in case that price, the price of the stock, happened to drop down quickly. I would be picking up stock at a lower price than I bought it from Weeden. Now, the stock price can drop on occasion when a big seller comes in and wants to sell 5,000 at the market. If I have a bid down there I am likely to pick up some of that stock.

I may also try one of the other regionals, but generally I don't want to tell too many people what I am doing, that is, I wouldn't try another regional on General Motors but I would try perhaps another third market house.

Q Who would be another third market house?

A Cantor-Fitzgerald is a fairly big one, J.S. Strauss is another, but the idea is to tell as few people as you can but to succeed if you can buy stock. I don't like to make too many inquiries because the more people know the more danger you have of somebody running ahead of you.

Now, on another type of stock it is a little more difficult.

show the items which were traded?

A It shows the total assets of the fund, the per cent increase or decrease from the previous week, the per cent increase or decrease since the first of the year. It shows the net asset value per share of the fund, and appropriate increases and decreases. It includes a listing of the entire portfolio broken down into industry groups and the percentage of the fund's assets in each industry group.

Q Mr. Greene, on the basis of these allocations which you have referred to, and on the basis of your conducting a large part of the fund's portfolio transactions, can you state your estimate of what a particular broker who has assisted in the sales of shares fares over an accumulated period of time, what in general he would have received in the nature of commissions?

MR. MEYER: I am not sure I understand the question.

THE COURT: It is pretty speculative and pretty hypothetical to me. I have some difficulty, too, Mr. Lee.

MR. LEE: Very well.

Q There has been testimony both in your deposition and in Mr. Chestnutt's deposition, and in Mr. Chestnutt's appearance here in Court, referring to a hope that a broker

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who brought in or assisted in the sale of fund shares would not see the last of the money that his customer formerly had, but at least have some benefit from it, and the figure of 2 per cent has been mentioned.

Do you have anything to say on that?

A While I was discussing our operations with brokers who were interested in assisting in the sale of fund shares, I would point out the fact that if the fund had brokerage business available, we would keep them in mind when we placed brokerage transactions. And I told them that if they needed a bench mark, we would try to do something around 2 per cent.

THE COURT: So that if a Broker "X" sold $100,000 worth of fund shares he might reasonably expect to receive brokerage commissions of $2,000 from the fund, is that it?

THE WITNESS: Yes, sir, except that I pointed out that the fund was under no obligation to do so and that we would try to do it but he can't really count on it.

THE COURT: But it worked out to that or a little bit more, as I remember Mr. Chestnutt?

THE WITNESS: Most of the time it worked out to be more, because it introduced that broker to us. We became acquainted with him as a person. He often

would visit our offices. He would inquire as to the fund's prospects on behalf of his customer or on behalf of the person that he interested in the purchase. So we, over a period of time, would get to know him, and if he did a competent job in handling orders and if his firm did a competent job, we might and often did continue to use that broker just because we were introduced to him and got to know him.

Q Is it your testimony that over a period of time brokers who had gotten their foot in the door got more than the 2 per cent generally?

A Could you repeat that question?

Q I say, is it your testimony that brokers who got their foot in the door because they had come to your attention through getting fund subscribers to come to you generally got more than 2 per cent?

A I can't really say that they generally got more than 2 per cent or approximately 2 per cent, because some of these fellows would just perhaps put in an order and we would do some brokerage business with them, and then they would just disappear and we would never hear from them. Normally, in our business the brokers taks quite a lot of the initiative, and if we just never hear from somebody we just do business with people who stay more in

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touch with us. So it doesn't always happen that way.

The ones that have received brokerage business over the years are the ones who have taken a personal interest in our organization, who we meet.

MR. LEE: Your HOnor, I intended to offer the New York Stock Exchange rules, but I understand from Mr. Meyer's concession yesterday that that won't be necessary in view of the fact that he states they make no claim we could have become a member of the New York Stock Exchange.

Is that clear on the record, Mr. Meyer?

MR. MEYER: We make no claim that Chestnutt Corporation or the fund or an affiliate of either could become a member of the New York Stock Exchange, and we have never made such a claim.

THE COURT: Your claim is that they could have become members of a regional exchange?

MR. MEYER: They could have become members of the NASD or a regional exchange, or both.

MR. LEE: Except for some small bit of information which I may be able to obtain over the week end and would like to put in through Mr. Greene or some other officer on Monday, that would conclude my direct examination of Mr. Greene.

THE COURT: All right, Mr. Meyer.

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CROSS-EXAMINATION

BY MR. MEYER:

Q Mr. Greene, Mr. Chestnutt had you read Footnote 82 at Page 173 of Exhibit 4. That's the 1966 PPI report. You were in Court yesterday when you heard Mr. Chestnutt testify that he thought that footnote represented a stupid comment, didn't you? Weren't you in Court then? Did you hear that?

A Yes.

Q Was that also your opinion, that it was a stupid comment?

THE COURT: Stupid comment?

MR. MEYER: That the SEC suggestion in Footnote 82 was stupid.

THE COURT: And also mistaken?

MR. MEYER: Yes.

THE COURT: Erroneous?

MR. MEYER: Right.

A I think the footnote is erroneous in that our fund would have to change its organization. It could no longer be an open-end diversified company and comply with that footnote, or the '40 Act could be changed by act of Congress.

Q Are you a lawyer, Mr. Greene?

A No.

Q Did you ask for a legal opinion on that point?

A In my view, that footnote is clear and the '40 Act is quite clear. I don't think one has to be a lawyer --

THE COURT: The question is: Did you ask a lawyer's opinion?

THE WITNESS: I believe I discussed this footnote in meetings or from time to time with Mr. Sabel and Mr. Lee, I believe. When this came up and this document was written and put in our hands, we discussed these items.

So I would say that although I didn't specifically search out a lawyer, I relied on the counsel of our firm.

Q Of your firm; you mean the counsel of Chestnutt Corporation?

A Yes.

Q Did you get a specific legal opinion on Footnote 82?

A I am sure when we discussed this, Stanley Sabel said this was clearly out of the question as far as our fund is concerned.

Q Did you share Mr. Chestnutt's opinion that the footnote was probably inserted by some staff

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member of the SEC and the SEC never paid any attention to it?

A I have no idea who wrote that footnote.

Q When the 10b-10 release came out in 1968, did you read that?

A I would like to glance at 10b-10, if I may.

Q Plaintiffs' Exhibit 3 for identification (handing) is actually Plaintiffs' Exhibit 37.

A I am generally familiar with this proposal, Release No. 8239.

Q Mr. Greene, I direct your attention to Page 8 of the release. Do you see at Page 8 where the Commission quotes Footnote 82 of the Public Policy Report at Page 173?

A I see where they have reprinted Footnote 82.

Q In quotation marks along with the accompanying sentence from the text, and that is the only quote that they make in here from PPI, is that correct?

A On this page,anyway.

Q Now, after the Commission repeated, in 1968, that suggestion in Footnote 82, were you still of the opinion that it was ill-founded?

A I am still of that opinion and that it did not correspond to the '40 Act.

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Q Did you ask for an opinion of counsel in 1968 as to the suggestion in Footnote 82?

A As I previously mentioned, there was nothing different in this particular restatement of this erroneous footnote than it was the first time it was presented in the PPI. In a business organization, in my business organization and in my business life, I don't always keep asking for formal opinions of counsel once I have been satisfied as to the answer or their opinion.

Q Now, Mr. Greene, in your direct testimony you discussed the ability to place business on regional stock exchanges. Mr. Chestnutt testified yesterday that he did not instruct brokers as a general rule to check the regional exchanges. Is that also your practice?

A Only in a particularly exceptional circumstance would I instruct a broker to check a regional, and, as I mentioned yesterday, I would only do so if I thought that particular security might trade out there more readily than it might in New York.

I also mentioned I may, and I have from time to time, tested that market with a small bid or a small offer, but I reiterate showing an indication on the regional will immediately broadcast your inquiry to the entire field, because every block trading house has representatives

on the floors of those regionals, and they are trying to find buyers and sellers.

Q You testified that a fifty or a hundred thousand share order placed on a regional would become quickly known.

Now, as a matter of fact, a fifty or one hundred thousand share order placed directly on the floor of New York would become quickly known, would it not?

A That depends a great deal on how that order is placed. If that order is placed with a competent broker who has that order not held and can use his discretion, one might never know about it.

Q Isn't it a fact that your fifty and one hundred thousand share orders are usually negotiated upstairs?

A If a block of stock crossed on the floor of any exchange, it is usually negotiated off the floor.

Q That's what I mean by upstairs.

THE COURT: Does "upstairs" mean off the exchange?

MR. MEYER: Off the floor, between brokers.

THE COURT: Off the exchange?

MR. MEYER: Well, the actual execution will be taken to the floor, as I understand it.

THE WITNESS: Yes.

MR. MEYER: And it will be done on the exchange

but the brokers handle it over the phone.

THE COURT: But they know in advance who is going to be the buyer and at what price?

THE WITNESS: Yes, your Honor.

THE COURT: All right.

Q Of course,once such an agreement is reached, I think you testified yesterday that it could with equal facility be taken to a regional exchange, is that correct?

A Yes.

Q In most cases?

A Yes.

Q And I think you also testified that it wouldn't make a great deal of difference in the ordinary case which regional exchange you took the order to.

A In most cases it doesn't matter which regional for those firms which have a practice of doing that type of business.

Q We were talking about the volume on regional stock exchanges. You mentioned Philadelphia. I just happened to pull out of the newspaper this morning a page indicating the volume on the regional exchanges of yesterday's transactions.

MR. MEYER: I will offer that in evidence.

MR. LEE: No objection.

MR. MEYER: Sure.

MR. LEE: It's obviously offered for whatever it's worth.

THE COURT: This document now being received as the next Plaintiffs' exhibit is a tabulation of what?

MR. MEYER: It is a tabulation of the give-ups directed by Chestnutt Corporation on American Investors Fund transactions on regional exchanges from October 1966 to November 1968.

MR. LEE: With one exception, your Honor. Those are directed by American Investors Fund rather than Chestnutt Corporation.

MR. MEYER: I don't agree with that characterization but there is no need to get into an argument.

THE COURT: And this is received in evidence subject to Mr. Lee pointing out any respects in which he finds it is inaccurate and, if it is not pointed out, I will assume that it is accurate. All right.

xxx (Plaintiffs' Exhibit No. 45 received in evidence.)

MR. LEE: Mr. Meyer, is there a copy here?

MR. MEYER: No. I hadn't intended to offer it. I will get you one.

Q Mr. Greene, when you were at First Boston, did you take the NASD exam for registered representative?

A No, I did not. I was waived the examination. The examination was waived in my case. I was a registered representative.

Q You were a registered representative of the NASD?

A But the NASD did not insist on my taking the test due to my experience and educational background.

Q I see.

Do I understand correctly you are a registered representative of the NASD?

A I was a registered representative with the First Boston Corporation and registered with the NASD, but when I left First Boston that expired.

Q You permitted it to lapse?

A Yes. Then when I joined Chestnutt Corporation or American Investors Corporation and American Investors Fund, I became registered as a securities dealer in the State of Connecticut and I have other registrations also in that state, at which time I took the NASD examination because it was required by the State of Connecticut.

Q I am sorry. You took which examination?

A I took the basic NASD examination which the State of Connecticut recognizes as part of the requirements

for being a registered broker-dealer in that state.

Q I see. And did you pass?

A Yes.

Q Now, Mr. Lee asked you whether you effected transactions for American Investors Fund and the other advisory clients of the Chestnutt Corporation or the Investment Management Corporation; do you recall that?

A Yes, I recall that.

Q And do you recall your answer to that?

A I said that I did.

THE COURT: Mr. Meyer, I am afraid we will have to go into that on Monday morning.

MR. MEYER: I am afraid you are right.

THE COURT: Please note that we will move on Monday morning ro Room 1505. It should be a much more convenient room than this one. We will meet there at 10:00 o'clock on Monday Morning.

All right, Mr. Clerk.

THE CLERK: Trial stands adjourned until 10:00 o'clock Monday morning.

(Adjournment taken to September 10, 1973 at 10:00 a.m.)

ROSALIND FOGEL and GERALD FOGEL

-against-

GEORGE A. CHESTNUTT, JR., ET AL

New York, N. Y.
September 10, 1973
10.00 a.m.

(Trial resumed)

THE COURT: All right. We'll continue with Mr. Greene.

W A R R E N K. G R E E N E, resumed.

CROSS EXAMINATION CONTINUED

BY MR. MEYER:

Q Mr. Greene, I think when we left off last week you were telling us that as the trader for Chestnutt Corporation you effected transactions for the Fund and / other advisory clients of Chestnutt Corporation, is that correct?

A Yes.

Q You are familiar with the rules of the NASD, are you not?

A Many of them.

Q Pardon me?

A Many of the rules.

Q Do you know how the term "broker" is defined in the

ties firm which is a member of the NASD.

Q I didn't hear that.

A I say it would take a certain amount of time and money and legal expertise in setting up, organizaing and running a securities firm which is a member of the NASD.

Q Well, Chestnutt Corporation was already set up, wasn't it, and organized and running?

A It was organized as an investment adviser.

Q Yes. What would be the additional expense? I'm not sure I understand that. You mean filling out these application forms, is that it?

A It is much more than that. For one thing, every NASD member has to keep books and records. It is subject to surprise audits by the National Association of Securities Dealers. It has rules and regulations to comply with.

Q Didn't Chestnutt Corporation keep books and records?

A It kept those books and records which are required by the Investment Advisers Act.

Q And how did they differ from the books and records required by the NASD?

A Since we aren't a member of the NASD, I don't know all the details of what records would necessarily be kept. I do know we keep a great number of records under the

Investment Advisers Act.

Q Did you have any particular rules and regulations in mind when you said you would have to comply with their rules and regulations?

A We would have to have a bookkeeping system, an organization, records of transactions and all the other details a brokerage firm or dealer, broker-dealer, must keep.

Q Don't you keep records of transactions now?

A I say we keep records under the Investment Advisers rule and under the SEC rules if it is related to American Investors Fund.

Q Yes.

A But I have no idea whether these are the same records. I believe that the NASD rules would superimpose a whole different set of regulations on top of what we are already doing.

Q But you don't know that; is that what you are saying?

A I know every brokerage firm, every securities firm has to establish a great body of work, of records, of bookkeeping, of records of transactions, of keeping track of customers' accounts, whether the customers' accounts have cash or securities in them. We have to be able to clear transactions or make an arrangement for the clearing of

transactions for customers. It is quite complicated.

THE COURT: No. But do you know of any particular records that you would have to keep as a member of the NASD that you weren't already keeping?

THE WITNESS: I would assume we would have to keep track of customers' accounts --

Q I don't want you to assume, Mr. Greene. The question is do you know of any.

A I would say I do know of some of these. Now, this is stretching my memory back to before 1965, when I was with a NASD member firm, and I know that we have to keep copies, that we had to keep copies at that time of transactions for customers, and that would certainly be one.

Q Do you mean to say that Chestnutt Corporation does not now keep records of transactions of its customers?

A It keeps records of those transactions and other records under the Investment Advisers Act. Keeping track of transactions is one such record. We also keep track of all orders that we place. We keep track of any of the reports of any execution from a broker.

Q You do that now.

A Yes.

Q You've testified before that Mr. Sabel had certain discussions that were held with the board of directors. Do

you recall that Mr. Sabel told the board of directors that Chestnutt Corporation did not qualify to become a NASD member?

A Yes, I recall discussions of that substance.

Q And do you recall that the board of directors relied on Mr. Sabel advising them that Chestnutt Corporation did not qualify for NASD membership?

A I believe most members of the board, if not all, were in agreement that we should not be a member of the NASD, nor should we be --

THE COURT: No, no. The question is not whether you should or should not, but could you if you wanted to?

THE WITNESS: In my view, we could not be a member of the NASD.

Q That is not the question. The question is: You've already testified that Mr. Sabel told the board of directors that Chestnutt Corporation did not qualify for membership. In your deposition testimony, which is in evidence, you testified at page 143, and I quote:

"I and the Board of Directors of the Fund have relied on the opinions of Mr. Sabel and Mr. Lee in regard to the fact that the Fund nor the Chestnutt Corporation could join the NASD."

And there must be a misprint, but it goes on to

read:

"Is that because we were a no load fund, with no dealer organization or underwriting affiliation, we were just plain not eligible."

Now, you adhere to that testimony, don't you?

A Yes.

THE COURT: Do you remember, Mr. Greene, why Chestnutt Corporation was not eligible?

THE WITNESS: Because we were not a broker or a broker-dealer. There was no need for us to be either one of those things.

THE COURT: I am not questioning the wisdom or the prudence, I am just questioning your eligibility, and you testified, just read, that you weren't eligible, and I take it from what you just this moment told me you weren't eligible because you didn't meet the definition of broker or broker-dealer; is that it?

THE WITNESS: That's right, sir.

THE COURT: All right. Let's go on, Mr. Meyer.

BY MR. MEYER:

Q Now, no inquiry was made of the NASD as to whether you were eligible or not, is that correct?

A That's correct.

Q Now, to come back to a subject that we dealt with

on Thursday, I believe, that is, the placing of transactions with Jesup & Lamont at the request or suggestion of IOS, did you have any idea in your own mind as to why IOS wanted you to place transactions with Jesup & Lamont?

A No.

MR. MEYER: I would like to offer as Plaintiffs' next exhibit an order of the Securities and Exchange Commission in the matter of IOS, Ltd., dated February 3, 1966.

THE COURT: Have you seen this?

MR. LEE: I think I know what it is, your Honor, but may I just scan it?

THE COURT: Of course.

(Pause)

MR. LEE: No objection as to authenticity. Objection as to relevance and materiality.

THE COURT: I'll take it.

Mark it.

(Plaintiffs' Exhibit 48 was received in evidence.)

BY MR. MEYER:

Q When was it again that you discontinued dealing with Jesup & Lamont on a large scale?

A There is no exact point. And we still deal with Jesup & Lamont.

Q But I'm talking about the substantial transactions that you were executing with them. I think Mr. Chestnutt testified that that continued through 1967, did it not?

A I believe we dealt with Jesup & Lamont for some time after that on a fairly substantial basis. And, by the way, we may, as time goes on, go back and we may do business with them again. We've never stopped doing business with them. But, as I say, some of their key personnel have left. Others have passed away.

THE COURT: And there was a connection between the interest of IOS and the dealing with Jesup & Lamont because you did significantly greater transactions while IOS had a big interest in the Fund than after IOS ceased to have that interest, isn't that so?

THE WITNESS: That's so.

Q Now, when this order of the SEC came down on February 3, 1966, it charged that Jesup & Lamont was paying over large amounts of the commissions to this Gloria Martica Clapp, who was depositing them in the Bahamian banks. Do you recall that?

A I recall reading about that in the papers.

Q Now, did you make any attempt to determine whether or not that allegation was true?

A As I recall, Mr. Sabel, in this regard, contacted

Jesup & Lamont and they indicated to him that our brokerage business with them had been done and conducted on a regular basis, and I don't think, according to Mr. Sabel, that Jesup & Lamont had any idea what she was doing. She was a registered representative of that firm and I think she eventually got fired. I'm not sure about that.

Q Did you make any inquiries of the staff of the SEC to find out whether they had any support for their allegations?

A I forgot just how that situation finished up.

THE COURT: Did you place the orders through Miss Gloria Martica?

THE WITNESS: Your Honor, I never laid eyes on this woman. I've never seen her. I only dealt with the man in Jesup & Lamont, one of the partners there.

THE COURT: But I would have thought that if you were dealing with Jesup & Lamont through other persons and then you learned that -- what is it? -- half of Jesup & Lamont's commissions were being paid over to one who was a complete stranger to you, you would have been terribly curious.

THE WITNESS: Your Honor, I had no idea that this was being done. Jesup & Lamont indicated that -- and I'm not just sure whether Mr. Sabel found out at this time, but I had no desire to get to know this woman at all.

THE COURT: No. But why would Jesup & Lamont have any legitimate reason whatsoever to give fifty per cent of their commissions to somebody that you didn't even know? I don't know what the effect of it is, but it just strikes me right away that something is rotten in Denmark. And if she lives in the Bahamas, presumptively it is rotten. I'm just curious. I want to give you every opportunity to enlighten me as to what your feeling was at the time.

MR. LEE: If the Court please, may I interject at this point?

THE COURT: Yes.

MR. LEE: There was extensive correspondence between American Investors Fund and the SEC and Jesup & Lamont and IOS and its counsel. Those letters were furnished to the SEC, and it was always represented to the Fund that there was no connection whatever between IOS and Jesup & Lamont, and those have been marked in the other case, which is not before your Honor, and copies of those are in the hands of plaintiffs' attorneys.

THE COURT: Look, we can get to that later. But this is the witness who is on the stand now and it is no time to argue the case. But while the witness is on the stand, if there is anything he wants to tell me about the payments to this woman in the Bahamas, I want to give him every opportunity

to do so, and then we can move on.

Have you told me everything you want to tell me, Mr. Greene?

THE WITNESS: No, sir.

THE COURT: All right.

THE WITNESS: As far as my dealings with Jesup & Lamont, I only dealt with the partners and men who were managing the trading desk. Those men were doing a very good job as far as I was concerned in handling orders. I had no knowledge of this Martica Clapp.

THE COURT: Until you read it in the Wall Street Journal, when this order came out.

MR. MEYER: February 1966.

THE COURT: And then I would have thought that you would have picked up the telephone and said to these men, and I'm sure they were very able, competent fellows, "Look, you guys are doing a terrific job, but why are you giving away fifty per cent of your commission to some woman in the Bahamas?"

THE WITNESS: Your Honor, I did not make that specific inquiry to Jesup & Lamont, but our counsel Stanley /Sabel did, and he received a reply back from Jesup & Lamont indicating that as far as we were concerned that just was not the case.

BY MR. MEYER:

Q That what was not the case? That the money was being paid to Mrs. Clapp? They didn't deny that did they?

A I'm not exzctly sure about the details of that, but as far as I understand it this was as much a surprise to them as it was to us, and I think that they terminated her operation, or her connection, with Jesup & Lamont shortly after that.

THE COURT: It couldn't have come as a surprise to them that they were paying half their commissions to her, because they were the guys that were doing it.

THE WITNESS: Your Honor, it might have been a surprise to them that she was putting the funds in a bank which was connected with IOS.

THE COURT: But suppose she was putting it in her own pocket. I still don't understand why they were doing it. They said: We've been doing it, but we didn't know she was connected with IOS.

But whoever she was connected with, what basis was there for paying her a nickel? She wasn't the one who got the business. She wasn't the one who was executing the orders. That's what I just don't understand.

But you've told us, I guess, everything that you can. Okay, let's go on.

BY MR. MEYER:

Q Did you share Mr. Chestnutt's aversion to kickbacks that he testified to the other day?

A Yes, I do. I don't believe institutional investors should be in the brokerage business, nor should they demand brokerage back from brokers on the basis of requesting brokers to give them back part of their commission, any more than an individual, say you, Mr. Meyer, should call your broker at the end of the day and ask him to give you back half of the commission on a s tock transaction.

I do believe in the concept of negotiated commissions.

Q You mean there is something wrong in getting money back for the Fund if you can get it, but if the money goes to somebody like Mrs. Clapp you don't ask any questions about it?

MR. LEE: Objection.

THE COURT: Yes, I'll sustain that objection. It is an argument, and you can certainly make it to me.

MR. MEYER: Okay.

I have no further questions.

THE COURT: All right, Mr. Lee.

MR. LEE: Thank you, your Honor.

they show the 17 1/2 per cent.

THE COURT: So the 17 1/2 per cent is 17 1/2 per cent of the space cost.

THE WITNESS: Correct.

THE COURT: So it is the same whether it is counter cards or newspaper ads.

THE WITNESS: It is the same in principle, yes. However, if we wanted to have our in-house agency, that 17 1/2 would accrue to us rather than an outsider.

THE COURT: I understand. All right.

CROSS EXAMINATION

BY MR. MEYER:

Q Mr. Currier, do you recall that Mr. Sabel and Mr. Lee advised the board of directors that American Investors Fund had no potential for recapture?

A Recapture of brokerage?

Q Of brokerage.

A Well, the word "potential" there may be a question to me. Mr. Sabel and Mr. Lee have consistently advised that we stay out of the brokerage business. In addition to that, that has been my feeling, that we didn't belong in it.

Q Let's stay away from your feelings for the moment. I want to find out what Mr. Sabel and Mr. Lee told you, and I'm not concerned with their advice that you should stay out

of the brokerage business. I want to find out if they told you about whether you could go into the brokerage business.

A No. It is my understanding that we --

Q Pardon me. Let me modify that. As to whether you could recapture brokerage commissions.

A Whether it is directly the result of their advice or what, I'm not sure. Chestnutt Corp. could have organized an affiliate, a broker, who could have engaged in brokerage on behalf of the Fund. I've known that. There are some limitations on that, as I recall. We could not have become a trader and shares listed on the New York Stock Exchange.

But I know we've known that we could organize an affiliate, but we rejected that.

Q Well, were you informed by Mr. Sabel or Mr. Lee that you did not qualify, Chestnutt Corporation did not qualify, for NASD membership?

A I would have to say yes.

Q And in fact you testified on deposition in this case in January of this year, did you not?

A I think so, yes.

Q And at that time you said, and I read to you from page 102 of your deposition:

"I have discussed with counsel any number of times and our counsel has insisted that we have no basis for

recapturing brokerage."

Then further down that page:

"Q When you say 'counsel," are you referring to Mr. Lee or to Mr. Sabel or to both of them?

"A It could have been either one. I'm not sure. I suspect that it was Mr. Sabel."

THE COURT: What is the question?

Q (Continuing) The question is whether you recall this testimony.

THE COURT: Is that your testimony?

THE WITNESS: Yes, sir.

THE COURT: All right. Let's go on.

Has this already been made part of the record?

MR. MEYER: This is all part of the record, yes.

THE WITNESS: May I add something?

Q Certainly.

A Reading from the deposition, I think I said we were advised we had no basis. That means that unless we did have a broker affiliate we had no basis.

Q And you were also advised that Chestnutt Corporation did not qualify for NASD membership.

A Correct.

Q Now I read you from page 107 to 108 of your deposition? This is your answer, your testimony:

JG 37 Currier-cross

"If there were a straight public policy that all that a mutual fund needs to do to get brokerage back and pay little or nothing for the brokerage, I would not want us to not recover. I would want us to recover.

"Q So if it could have been done with little or no expense or effort, you would have wanted it to be done, is that correct?

"MR. LEE: I object.

"A Short of our organizing any affiliated brokerage activity.

"Q By 'activity' you mean other than collecting checks and doing the bookkeeping for the recapture, is that it?

"A Correct."

Do you adhere to that testimony?

A I do.

Q And is it also true that you never inquired from any other attorneys or anyone else aside from Mr. Lee and Mr. Sabel as to the possibility of recapturing brokerage commissions?

A It is true.

MR. MEYER: I have no further questions.

THE COURT: Mr. Lee?

MR. LEE: No further questions, your Honor.

THE COURT: Thank you, Mr. Currier.

CROSS EXAMINATION

BY MR. KRASNER:

Q Mr. May, do you know the term "recapture of brokerage commissions"?

A I am vaguely familiar with it, yes.

Q Are you aware of the fact that other mutual funds have been and are continuing to recapture brokerage commissions?

A I am aware some of them are, yes.

Q Was the subject of recapture of brokerage commissions ever discussed during the time you were a director of American Investors Fund?

A Not to my recollection.

Q Do you know what the term "give-ups" is, Mr. May?

A In what context?

Q In the context of brokerage commissions.

A No, I am not familiar with that term.

Q Are you aware of the fact, Mr. May, that during the period you were a director of the fund, American Investors Fund directed brokers to give up a portion of their commissions to other brokers?

A I was not aware of that, no.

Q You say you read the prospectuses and proxies of American Investors Fund for the years 1964 and 1965?

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A Until September, 1965, yes.

Q Do you recall whether there was any reference in any of those prospectuses or proxy statements to give-ups?

A No, I do not recall.

Q Mr. May, do you know whether it is the practice in the advertising agency business for advertising agencies to give up a portion of their commissions or fees to other advertising agencies at the request of their customers?

A I believe it has been done, yes.

Q Has American Can engaged in this practice?

A Not to my knowledge.

Q Do you consider this to be a proper practice?

A I don't know the legal aspects of it, but I would assume if it is being done it is proper, yes.

Q You consider it proper for an advertising agency that receives commissions from a company to give up a portion of these commissions to another advertising agency who had nothing to do with the work?

A Oh, no, not in that case I wouldn't. If they had value received or service received, I think it would be proper, yes.

Q So that if the other recipient advertising agency was not giving any services in connection with the

particular advertising campaign, you would think it would be improper for them to receive a portion of the commissions?

A I would be apt to question it, yes.

Q Are you aware of the fact that American Investors Fund did direct brokers to give up a portion of their commissions to other brokers who did not participate at all in the particular transaction upon which they were getting the give-up?

A I was not aware of that, no.

MR. KRASNER: I have no other questions.

THE COURT: Mr. Lee.

REDIRECT EXAMINATION

BY MR. LEE:

Q Mr. May, during the time you were on the board of directors or thereafter, has anything ever come to your attention that the fund or the adviser was ever in violation of any rule of any stock exchange?

A No.

MR. LEE: No questions.

THE COURT: Mr. Krasner, anything else?

MR. KRASNER: No.

THE COURT: Thank you, Mr. May.

(Witness excused.)

MR. LEE: Your Honor, there was introduced in

ARTICLE XX

Commissions

¶ 1476 Obligation to Charge or Collect—Without Rebate

SEC. 1. Commissions shall be charged and collected upon the execution of all orders for the purchase or sale for the account of members or of non-members of the Exchange, of securities admitted to dealing upon the Exchange, except under such Rules as may be adopted by the Board of Governors with respect to special offerings and except as herein further expressly provided; these commissions shall be at rates not less than the rates in this Article prescribed; and they shall be absolutely net and free from any rebate, return, discount or allowance, in any shape or manner, or by any method or arrangement, direct or indirect.

No bonus or percentage or portion of a commission, whether such commission be at or above the rates herein established, or any portion of a profit, shall be given, paid or allowed, directly or indirectly, or as a salary or as a portion of a salary, to any person or persons for business sought or procured for any member, member firm or member corporation of the Exchange, except as herein expressly permitted.

Commissions on other Exchanges

Notwithstanding the provisions of this Article, any member, member firm or member corporation of the Exchange holding a membership or associate membership in another exchange located in the United States or Canada, or registered with a Canadian exchange as being entitled to a return of commission from members of said exchange, may in respect of transactions made on such other exchange charge the rates of commission prescribed by such other exchange.

Amended
April 18, 1945;
November 20, 1947;
September 23, 1953.

¶ 1477 Commissions on Stocks, Rights and Warrants

*SEC. 2. Commissions shall be as follows:

STOCKS, RIGHTS AND WARRANTS
(Hereinafter referred to as "stocks")

Non-member rates (stocks)

(a) On business for non-members of the Exchange, including joint account transactions in which a non-member is interested; and on transactions for partners not members of the Exchange, the commission rate per share shall be not less than the following:

*Amended
November 20, 1947;
November 18, 1953;
May 1, 1958;
April 1, 1959.

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Stocks $1 per share and above

(1) On stocks selling at $1.00 per share and above commissions shall be based upon the amount of money involved in a single transaction and shall be not less than the rates hereinafter specified:

(i) Subject to the provisions of paragraph 2(a) (1) (iii), 2(d), and 2(f), on each single transaction not exceeding 100 shares, in a unit of trading; a combination of units of trading; or a combination of a unit or units of trading plus an odd lot

Commission

2% on first $400 of money involved plus
1% on next $2,000 of money involved plus
½% on next $2,600 of money involved plus
1/10% on money involved above $5,000 plus $3.00

(ii) On odd lots (less than a unit of trading)

Same rates as paragraph (i) above, less $2.00, subject to the provisions of paragraphs 2(a) (1) (iii), 2(d), and 2(f).

(iii) Notwithstanding the foregoing:

(a) when the amount involved in a transaction is less than $100, the minimum commission shall be as mutually agreed;

(b) when the amount involved in a transaction is $100 or more, the minimum commission charge shall not exceed $1.50 per share or $75 per single transaction, but in any event shall not be less than $6 per single transaction;

Stocks below $1 per share

(2) On stocks selling below $1.00 per share commissions shall be on a per share basis and shall be not less than the following:

Price per Share	*Rate per Share*
	cents
1/256 of $1	0.1
1/128 of $1	0.15
1/64 of $1 and above but under 2/32 of $1	0.5
2/32 of $1	0.5
Over 2/32 of $1 but under 8/32 of $1	1.0
8/32 of $1 and above but under 1/2 of $1	2.0
1/2 of $1 but under 5/8 of $1	3.0
5/8 of $1 but under 3/4 of $1	3.75
3/4 of $1 but under 7/8 of $1	4.5
7/8 of $1 but under $1	5.25

Notwithstanding the foregoing, when the amount involved in a transaction is less than $100, commissions shall be as mutually agreed; when the amount involved is $100 or more, the minimum commission shall be not less than $6 or the rate per share, whichever is greater.

Rates to members—Clearance business (stocks)

(b) On business for members, member firms, and member corporations of the Exchange when a principal is not given up, commissions shall be as mutually agreed subject to such regulations as the Board of Governors may deem proper.

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• • • *Directives of Board of Governors*

The Board of Governors has adopted the following Directives:

It is the policy of the Exchange to permit clearance arrangements between members at not less than 50% of non-member rates, but the Board will consider requests for exceptions in particular cases.

Notwithstanding the foregoing, members may establish and maintain bona fide correspondent relationships upon a fully disclosed basis in which rates less than the rates prescribed herein may be charged provided in each instance the terms of such relationship shall be set forth in a written memorandum filed with the Exchange and the establishment as well as the maintenance of every such relationship shall be subject to approval of the Board of Governors.

Investment Fund Orders

Members and member organizations may accept orders for execution on the Exchange from Investment Funds, registered under the Investment Company Act of 1940, on a give-up basis to include other members, subject to the following conditions:

1. *Designate Give-up:* The Investment Fund shall in each instance, at the time the order is placed, designate it specifically as one to include on a give-up basis other members.

2. *Give-up for Member:* If the order is designated as one to be executed on a give-up basis for members, the executing member may credit not to exceed 65% of the commission earned to a special account to be identified in the member's records as "Member's Investment Fund Give-up Account."

3. *Give-up for Non-Member:* If the order is designated as one to be executed on a give-up basis for non-members who are members of the National Association of Securities Dealers, the executing member may credit not to exceed 40% of the commission earned to a special account to be identified in the member's records as "Non-Member's Investment Fund Give-up Account".

4. *Give-up for Members and Non-Members:* If the order is designated as one to be executed on a give-up basis for both members, and non-members as defined in section 3, the executing member shall not credit to the respective special give-up accounts more than a combined total of 50% of the commission earned.

5. *Disbursement in Calendar Year:* All commissions credited to special Investment Fund Give-up Accounts shall be disbursed as provided in Paragraph 2, during the calendar year in which they are credited to such accounts.

6. *Members Advise Exchange:* Members proposing to transact business for Investment Funds pursuant to the foregoing shall so advise the Exchange in writing, stating that such business has been or may be accepted.

7. *Maximum Rate:* The maximum rate of 65% on Investment Fund orders shall be effective regardless of any other rate which may be approved for the establishment and maintenance of a bona fide correspondent relationship between members and member organizations.

Amended
February 4, 1953.
May 7, 1964.
November 8, 1965, effective November 9, 1965.
June 15, 1966, effective June 20, 1966.

Floor commissions (stocks)

(c) On business for members, member firms, and member corporations of the Exchange when a principal is given up, commissions shall be based on a rate per share as follows:

Stocks $1 per share and above

(1) On stocks selling at $1.00 per share and above, the commission rate per share shall be not less than the following:

Price per Share	*Rate per Share*
	cents
$ 1 and above but under $ 2	1.25
$ 2 and above but under $ 5	1.40
$ 5 and above but under $ 10	2.10
$ 10 and above but under $ 20	3.10
$ 20 and above but under $ 40	3.65
$ 40 and above but under $100	3.85
$100 and above but under $150	4.35
$150 and above but under $200	4.50
$200 and above	5.00

Amended
October 28, 1958.

Stocks below $1 per share

(2) On stocks selling below $1.00 per share the commission rate per share shall be not less than the following:

Price per Share	*Rate per Share*
	cents
1/256 of $1	0.05
1/128 of $1	0.1
1/64 of $1 and above but under 2/32 of $1	0.1
2/32 of $1	0.25
Over 2/32 of $1 but under 8/32 of $1	0.25
8/32 of $1 and above but under 1/2 of $1	0.5
1/2 of $1 and above but under $1	0.5

Notwithstanding the foregoing, when the amount involved in a transaction is less than $10, the commission shall be as mutually agreed.

Minimum

The minimum commission on any transaction for members shall be 25¢.

Definition of transaction

(d) For the purpose of this Section 2

(1) in respect of stocks selling at $1.00 per share and above, a single transaction shall be deemed to include all purchases or sales for one account, of a single security, pursuant to a single order

(i) amounting to 100 shares of a security in which the unit of trading is 100 shares

(ii) amounting to less than the unit of trading

(iii) amounting to 100 shares or less in one transaction or a series of transactions, pursuant to a single order entered at a single price or at the market, of a security in which the unit of trading is less than 100 shares.

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If such series of transactions includes an execution in an amount of less than the unit of trading and the order was at a price not more than the usual odd lot differential away from the limit on the full lot order, such odd lot transaction may be deemed to be a part of the single transaction.

(2) in respect of stocks selling at less than $1.00 per share, a single transaction shall be deemed to include all purchases or sales for one account, of a single security, pursuant to a single order, irrespective of the size of the order.

(e) In determining the amount involved in a transaction, commissions and taxes shall be disregarded.

Special rates

(f) Notwithstanding the rates prescribed elsewhere in this Section 2, the commission rates to members and non-members upon stocks which, pursuant to call or otherwise, are to be redeemed within twelve months shall be such rates as may be mutually agreed upon, provided, however, that such rates shall apply to transactions in any specific stock only after announcement to that effect has been made by the Exchange, and provided, further, that the Board of Governors may determine special rates on any or all such securities.

Non-member rates (bonds)

(g) On business for non-members of the Exchange, including joint account transactions in which a non-member is interested; and on transactions for partners not members of the Exchange, the commission rates shall be not less than the following:

ON BONDS

Price per $1,000 of Principal	*Rate per $1,000 of Principal*
Selling at less than $10	$ .75
Selling at $10 and above but under $100	1.25
Selling at $100 and above	2.50

Amended
October 17, 1956.

Rates to members—Clearance business (bonds)

(h) On business between members of the Exchange when name of principal is not given up, the commission rates shall be not less than the following:

ON BONDS

Price per $1,000 of Principal	*Rate per $1,000 of Principal*
Selling at less than $10	$ .50
Selling at $10 and above but under $100	.62½
Selling at $100 and above	1.25

Amended
October 17, 1956.

Floor commissions (bonds)

(i) On business between members of the Exchange when name of principal is given up, the commission rates shall be not less than the following:

ON BOND

Price per $1,000 of Principal	*e per $1,000 of Principal*
Selling at less than $10	$ .25
Selling at $10 and above but under $100	.37½
Selling at $100 and above	.75

Minimum

The minimum commission on any transaction for members shall be 25¢.

Amended
October 17, 1956.

Special rates

(j) Notwithstanding the foregoing, the commission rates to members or non-members upon obligations of the United States, Puerto Rico, Philippine Islands and States, Territories and Municipalities therein; upon bonds or notes having five years or less to run; and upon bonds or notes which, pursuant to call or otherwise, are to be redeemed within twelve months, shall be such rates as may be mutually agreed upon; provided, however, that the Board of Governors may determine special rates on any or all such securities.

¶ 1478 Special Rates

SEC. 3. Special rates of commission for particular securities may be established by the Board of Governors whenever in its judgment such changes shall be for the best interest of the Exchange.

¶ 1479 Clearing Charges

SEC. 4. When a member, or member firm, or member corporation having made or caused to be made a contract for his or its own account on the Floor of the Exchange for the purchase or sale of stock arranges to have such contract cleared by another member or member firm, such clearing member or member firm shall charge and collect from such executing member or member firm a clearing charge therefor, as may be mutually agreed upon.

¶ 1480 Dealings in Securities of Original Issue

SEC. 5. If a member of the Exchange or member firm or member corporation engages in transactions in which the member or firm or corporation is acting as a dealer in securities of original issue, the rates of commission prescribed in this Article shall not apply to such transactions if not made on the Exchange; provided, however, that such transactions shall be subject to such regulations as the Board of Governors may from time to time prescribe.

¶ 1481 Proposition to Violate

SEC. 6. No member, member firm or member corporation shall make a proposition for the transaction of business at less than the minimum rates of commission prescribed in this Article.

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March 5, 1973

PBWSE INSTITUTIONAL MEMBER LIST

STITUTIONAL AFFILIATE	DATE OF ADMISSION	PARENT ORGANIZATION
tna Financial Services, Inc. 1 Farmington Avenue rtford, Conn. 06115 one: (203) 273-0123 nber: D. Russell Armentrout, Jr.	6-28-71	Aetna Life and Casualty
lstate Trading Company lstate Plaza rthbrook, Ill. 60062 one: (312) 291-5781 nber: Ronald E. Peterson	11-15-71	Allstate Insurance Co.
erican Money Management Corporation Josephine Street te 505 ver, Colo. 80206 ne: (303) 771-8030 ber: James H. Galbreath	12-16-70	Western Empire Financial Inc.
r Securities Corporation Wall Street York, N.Y. 10005 ne: (212) 422-7282 ber: Ralph M. Carruthers	2-17-66	Julius Baer (Banking)
G. Securities Corporation tford, Connecticut 06115 ne: (203) 243-8811 ber: Harold E. Bigler, Jr.	9-29-62	Connecticut General Life Insurance Co.
Securities Corp. South Michigan Avenue cago, Ill. 60604 ne: (312) 822-7908 ber: Richard T. Fox	5-22-70	CNA Financial Corp.
Securities Corporation Milk Street on, Mass. 02107 e: (617) 426-2600 er: Donald H. Whitney	9-18-72	Commercial Union Companies

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monwealth Chemical curities, Inc. John Street York, N.Y. 10038 ne: (212) 349-5460 ber: Julius Kleinman	12-29-72	Federated Equity Corp.
necticut Nutmeg Securities Trinity Street tford, Conn. 06115 ne: (203) 566-5050 ber: Robert I. Berdon	12-14-72	State of Connecticut
lman & Company, Inc. California Street te 2810 Francisco, Calif. 94104 ne: (415) 986-0246 ber: Thomas Finch	1-26-70	Capital Funding Corp. (Life Insurance)
Dreyfus Sales Corp. Fifth Avenue York, N.Y. 10022 ne: (212) 935-8484 ber: Robert S. Clancy	12-24-68	Dreyfus Funds
wment Securities Corp. Franklin Street ton, Mass. 02110 ne: (617) 357-8480 ber: Paul F. Duffy	8-17-70	Endowment Management & Research Corporation (Managers Mutual Fund Major Endowment Fund)
co Securities, Inc. . Box 581 West 52nd Street York, N.Y. 10001 e: (212) 757-3337 er: Walter R. Knortz	1-4-72	Equitable Life Assurance Society of the United States
ty Services, Inc. onal Life Drive pelier, Vt. 05602 e: (802) 223-3431 er: Harold Engelman	2-10-72	National Life Insurance Co. of Vermont

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›partners Securities Corporation ›rld Trade Center :e 3411 York, N.Y. 10022 ıe: (212) 466-6100 ›er: Thomas R. Koerick	4-2-68	Credit Lyonnaise, Paris Commerzbank, Germany Banco di Roma, Italy
ıncial Service Corporation : America ıncial Service Bldg. lmont and Cain Streets ınta, Ga. 30303 ıe: (404) 659-1234 ›er: William F. Carter	2-13-68	Financial Service Corp. International (Insurance and Diversified Investments)
.ders Securities Corp. First National Bank Building ›er, Colo. 80202 e: (303) 292-1820 ›er: Bjorn K. Borgen	5-19-71	Founders Mutual Depositor Corporation
y Friedlander & Co., Inc. Broadway York, N.Y. 10005 e: (212) 425-7740 ›er: Joel D. Aronson	2-5-71	City Investing Co. (Financial Conglomerate)
c Securities, Inc. Gamble Drive eapolis, Minn. 55416 e: (612) 374-6434 ›er: E. Charles Williamson, Jr.	6-15-72	Gamble Skogmo, Inc.
ral Investment Sales Corporation North Farwell Avenue aukee, Wisc. 53202 e: (414) 272-2421 ›er: Wallace C. Berg	9-4-69	GL Enterprises, Inc. (Insur.)
wood Securities, Inc. lenwood Avenue Orange, New Jersey 07017 e: (201) 674-7575 ›er: Paul Kreindler	9-9-68	Pennsylvania Life Co.

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rdian Advisors, Inc. Park Avenue South York, N.Y. 10003 ne: (212) 473-10003 ber: James B. Pirtle	8-7-70	Guardian Life Insurance Co. of America
sey, Stuart & Co., Inc. LaSalle Street cago, Ill. 60690 ne: (312) 782-3900 ber: Ernest B. Kelly, Jr.	4-2-70	Lincoln National Corp. (Bank Holding Company)
tford Securities Company, Inc. tford Plaza tford, Conn. 06115 ne: (203) 547-5000 ber: Gerard T. Lynch	12-17-71	Hartford Fire Insurance Co.
Capital Services, Inc. Maiden Lane York, N.Y. 10038 ne: (212) 530-6163 ber: Rogers Bayles	12-31-71	The Home Insurance Company
rial Securities, Inc. . Box 1386 9 Wayzata Boulevard eapolis, Minn. 55440 e: (612) 544-1531 er: Thomas P. Kozlak	3-19-69	The Saint Paul Companies, Inc.
Trading Corporation 1648 Suburban Station Bldg. Arch Street adelphia, Pa. 19101 e: (215) 241-4000 er: Donald G. Heth	6-24-68	INA Corporation
rcapital Distributors, Inc. Broadway York, N.Y. 10019 e: (212) 581-3360 er: Dennis H. Greenwald	5-22-70	McGraw-Hill, Inc./ Standard & Poor's Corp.

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ercapital Investors, Inc. 1 San Joaquin Hills Road port Beach, Calif. 92660 ne: (714) 644-8673 ber: Jack E. Glassford	8-13-69	Interfinancial Inc. (Life Insurance)
fferies & Company, Inc. South Figueroa Street Angeles, Calif. 90017 ne: (213) 624-3333 ber: Boyd L. Jefferies	8-5-71	Investors Diversified Services, Inc.
sas City Securities Corp. Crown Center). Box 19237 sas City, Mo. 64141 ie: (816) 283-4210 ber: Wesley J. Teasdale PBW Trading Floor	3-19-69	United Funds, Inc.
tone Securities Company, Inc. ligh Street on, Mass. 02104 ie: (617) 726-1200 er: Robert M. Smith	4-25-72	Keystone Custodian Funds, Inc.
's Securities Corp. Fifth Avenue York, N. Y. 10019 e: (212) 586-4400 er: Jacob Stillman	1-3-72	Loew's Corporation
gie, Mason-Hagan, Inc. East Main Street mond, Va. 23219 e: (703) 649-0331 er: John C. Hagan, III Walter W. Craigie	6-8-72	Fidelity Corporation (Insur.)

ormer Member Firm, Mason-Hagan, Inc. was admitted to membership on
-8-52. Their membership was ceased in June, 1972, at which time
raigie, Mason-Hagan, Inc. became the PBW member.)

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NSTITUTIONAL AFFILIATE	DATE OF ADMISSION	PARENT ORGANIZATION
orth American Equity Corporation 900 Avenue of the Stars uite 330 os Angeles, California 90067 hone: (213) 553-3581 ember: Robert A. King	12-30-70	Equity Funding Corp. of America (Life Insurance and Mutual Funds)
enn Mutual Securities Corp. 30 Walnut Street hiladelphia, Pa. 19105 hone: (215) WA 5-7300 ember: Edwin W. Crysler, Jr.	6-15-72	The Penn Mutual Life Insurance Co.
hoenix Equity Planning Corp. he American Row artford, Conn. 06115 hone: (203) 278-1212 ember: Edward P. Ward	7-17-72	Phoenix Mutual Life Insurance Co.
lace d'Armes Securities Inc. 2 Notre Dame East ntreal 126 nada one: (514) 861-4721 mber: Tancrede Sicard	10-1-71	Quebec Federation des Caisses Populaires des Jardins
rteous and Company, Inc. Penn Center Plaza iladelphia, Pa. 19102 one: (215) 564-3533 mber: Douglas K. Porteous	8-15-66	Provident Fund for Income, Inc.
uco Securities Corporation udential Plaza wark, New Jersey 07101 one: (201) 336-4246 nber: John F. Winch	4-15-71	The Prudential Insurance Company of America
ublic Securities Corporation 30 K Street NW shington, D.C. 20006 one: (202) 223-1000 ber: Charles W. Steadman	6-14-67	Steadman Security Corporation (Mutual Funds)

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t. Johns Securities, Inc. 050 Edgewood Court . O. Drawer B acksonville, Fla. 32203 hone: (904) 387-1588 ember: Charles M. Thompson	7-9-68	D. D. I. Inc. (Family Holding Company Diversified Investments)
urety Equities Corporation . O. Box 2520 urety Financial Center alt Lake City, Utah 84111 hone: (801) 487-7411 ember: L. James Ellsworth	3-8-71	Surety Life Insurance Co. of Salt Lake City
MR Securities, Inc. 45 Park Avenue ew York, N.Y. 10017 hone: (212) 661-4400 ember: Gerard Leimkuhler	4-20-72	Tsai Management & Research Corporation
oronto Securities Company he Crown Center . O. Box 19237 ansas City, Mo. 64141 one: (816) 283-4207 mber: Richard T. Taylor, Jr.	10-13-69	United Funds of Canada
avelers Securities Corporation Tower Square rtford, Conn. 06115 one: (203) 277-0111 mber: Peter F. McKay	12-30-71	Travelers Insurance Co.
S-DB Corporation Wall Street w York, N.Y. 10005 one: (212) 943-5900 mber: Donald E. Williams	11-9-70	Union Bank of Switzerland/ Deutsche Bank of Frankfurt, Germany
lnut Securities, Inc. 0 Wall Street w York, N.Y. 10005 one: (212) 422-6915 mber: Joseph M. O'Brien	11-12-68	NFIC, Inc.
tpark, Inc. tminster at Parker zabeth, N.J. 07207 ne: (201) 354-1770 (Member: Roger T. Wickers)	12-29-72	Anchor Fund

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Union Calendar No. 1046

89th Congress, 2d Session - - - - - - House Report No. 2337

Report of the Securities and Exchange Commission on the PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH

REPORT

OF THE

COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

Pursuant to Section 136 of the Legislative Reorganization Act of 1946, Public Law 601, 79th Congress, and House Resolution 35, 89th Congress

DECEMBER 2, 1966.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

In the Commission's view, the adoption of an express statutory standard of reasonableness for managerial compensation is the most feasible way of improving shareholder protection with a minimal disruptive effect on industry structure. The Commission has considered other proposals in this area. These range from proposals to strengthen disclosure, shareholder voting rights and the position of unaffiliated directors to proposals for requiring the internalization of the management function. Proposals with respect to disclosure, voting and unaffiliated directors were rejected as wholly unrealistic. On the other hand, proposals calling for internalization were viewed as too sweeping to be warranted at this time.[71]

(e) Sales of management organizations

Sales of the assets of, or controlling blocks of stock in, adviser-underwriter organizations have caused funds to change managers. Since the management organization's control of a fund often is an exceedingly valuable asset, the price paid for its stock or its assets reflects the expectation that the buyers will be able to succeed to the advisory, brokerage and underwriting revenues obtainable from this control relationship.[72]

Sales of management organization are of paramount importance to the fund and its shareholders. The conflict of interests involved usually is a striking one. It is in the interest of the retiring manager to obtain for himself the highest price for this relationship. The interest of the fund and its shareholders, on the other hand, is to obtain the best available management at a reasonable cost.[73]

Although the Act requires that the new advisory relationship be approved by the holders of a majority of the fund's shares, this safeguard has not adequately protected the shareholders' interest in all cases.[74] In the Commission's view, transfers of the management relationship that are adverse to the interest of the funds and its shareholders should be prevented. The Commission believes that this objective can be achieved without discouraging fund managers who are unable or unwilling to continue serving in that capacity from terminating their relationship and without depriving them of an opportunity to obtain a fair return from their efforts in organizing and developing the investment company.[75]

Accordingly, the Commission recommends that the Act be amended to prohibit sales of management organizations if the sale or any express or implied understanding in connection with the sale imposes additional burdens on the investment company or its shareholders or limits its future freedom of action.

3. Chapter IV—Portfolio Transactions

(a) The securities markets

The substantial brokerage costs that investment companies pay are an increasingly important source of revenue to the securities industry. In 1965, these charges amounted to more than $100 million for the mutual fund sector alone.[76]

[71] Pp. 147-149, infra.
[72] P. 149, infra.
[73] P. 151, infra.
[74] P. 152, infra.
[75] Pp. 152-153, infra.
[76] P. 155, infra.

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Portfolio holdings of investment companies tend to be heavily concentrated in securities listed on the New York Stock Exchange.[77] While most investment company transactions are executed on that exchange, the companies also can buy and sell NYSE-listed securities on seven regional exchanges [78] and in the so-called "third market" segment of the over-the-counter market.[79] Investment companies also are important holders of securities that are traded only in the over-the-counter market, and a few companies invest principally or exclusively in such securities.[80]

Charges for the execution of transactions in the over-the-counter market are subject to negotiation.[81] In the exchange markets, however, brokerage commissions are governed by exchange minimum commission rate schedules which do not provide for a volume discount. The exchange commission on an order for 10,000 shares of a given security is exactly 100 times the commission for a 100-share order.[82]

Hence, though exchange members compete vigorously among themselves, with members of other exchanges and with nonmember broker-dealers for investor patronage in exchange-traded securities, they do not do so on the basis of direct price competition.[83] Nonexchange members who operate in the third market, however, are not bound by exchange commission rate schedules. Often they are able and willing to handle orders for institutional customers in NYSE-listed securities for less than exchange members have to charge.[84]

(b) Allocation of mutual fund brokerage

Exchange members also are willing to execute and clear exchange transactions for mutual funds and other large institutional customers for a fraction of the commissions they must charge them.[85] They allow mutual fund managers to allocate a substantial portion of the brokerage to other brokers who had nothing to do with the execution of the transaction on which the brokerage is earned.[86]

Some of this brokerage is allocated to broker-dealers for nonsales services, including investment research, investment recommendations, private wire and teletype connections, pricing of fund securities portfolios and, in a few instances, custodial services.[87] However, the managers of most dealer-distributed funds which are not closely affiliated with brokerage houses use a substantial portion of the funds' brokerage to pay dealers extra compensation for sales of fund shares.[88] The amount of brokerage available for sales depends upon a variety of factors, but generally the larger funds and fund complexes are able to use a much greater percentage of their brokerage for sales than are the smaller ones.[89]

The simplest way to reward broker-dealers for nonbrokerage services is to place brokerage orders with them. However, placing orders with substantially all of the member firms that sell fund shares and

[77] P. 157, infra.
[78] Pp. 157-158, infra.
[79] Pp. 159-161, infra.
[80] P. 158, infra.
[81] Pp. 158-159, infra.
[82] Pp. 156-157, infra.
[83] P. 157, infra.
[84] Pp. 159-160, infra.
[85] Pp. 162-163, infra.
[86] P. 163, infra.
[87] Pp. 161-163, infra.
[88] Pp. 164-165, infra.
[89] Pp. 165-167, infra.

provide other services would impose burdens on fund trading departments and on the ability of fund managers to acquire or dispose of portfolio securities in the most efficient and inexpensive way.[90] Most fund managers, therefore, attempt to distribute fund brokerage to a large number of dealers who sell their shares by using the "customer-directed give-up." They direct the broker who executes an order and receives the commission to "give up" portions of that commission to one or more designated brokers who have no connection with the transaction.[91] Because of the profitability of fund commission business, many NYSE members are willing to give up as much as 60 percent of the commissions on such orders—some will give up 70 percent or even more.[92]

NYSE rules prohibit members from sharing with nonmembers commissions on transactions executed on that exchange.[93] Fund managers, therefore, place orders for NYSE-listed securities traded on regional exchanges with brokers who are members of both the NYSE and one or more regional exchanges in order to channel give-ups to dealers in fund shares who are members only of a regional exchange. Regional exchanges also have competed with the NYSE for mutual fund business by fashioning rules that allow give-ups of brokerage income to dealers who sell fund shares but who are not members of any exchange. Increases in regional exchange trading volume in recent years are largely due to the use of regional exchanges by the funds.[94] Mutual fund transactions on regional exchanges often are "crosses" of orders that have been arranged and negotiated elsewhere and later brought to the floor of the exchange for formal execution.[95]

(c) *Impact of mutual fund reciprocal and give-up practices*

Although reciprocity—doing business with people who do business with you—is an accepted custom of the business world, in the mutual fund industry it takes on a unique character. The use of the funds' brokerage commissions as extra compensation to retail sellers of fund shares primarily benefits their adviser-underwriters rather than the funds and their shareholders.[96]

Under existing commission rate structures, mutual fund shareholders could derive greater benefits from their brokerage commissions if the give-up portions of the commissions were transmitted to the funds themselves or their adviser-underwriters for the purpose of reducing management costs. However, in the face of competitive pressures managers of the dealer-distributed funds have not used brokerage for this purpose.[97]

The increasing importance of brokerage as compensation for sales of fund shares presents a potential for harmful effects on fund management. The need to allocate brokerage for sales may tempt fund advisers to skimp on the allocation of brokerage for investment advice or other nonsales services of greater benefit to the funds than the accelerated sale of new shares.[98] Even more important, it creates pressures for "churning," i.e., frequent sales and purchases of

[90] Pp. 167–168, infra.
[91] Pp. 169–170, infra.
[92] P. 170, infra.
[93] Ibid.
[94] Pp. 170–171, infra.
[95] Pp. 171–172, infra.
[96] P. 172, infra.
[97] Pp. 172–173, infra.
[98] Pp. 173–174, infra.

continue to serve nonfund clients [158] or brokerage firms for whom the management of the fund is but one of a variety of activities.[159]

No-load shares are sold by the fund itself with the aid of its investment adviser. The absence of a sales load precludes the development of the complex distribution systems and the exertion of the vigorous direct selling efforts characteristic of the load funds. No-load funds employ no salesmen. However, they and their advisers stimulate share sales [160] by advertisements in newspapers and periodicals, stating that the fund is a no-load fund and inviting requests for copies of its prospectus.[161] And some no-load funds encourage brokers to recommend their shares to prospective investors by directing their portfolio brokerage business to those brokers who promote the sale of their shares.[162] Other significant sources of business are the adviser's general nonfund advisory clientele,[163] recommendations by lawyers, bankers, and others on whom people rely for investment advice; articles in the financial press; [164] the reputation of a particular fund for investment expertise; and new investment by existing shareholders.[165]

These methods of obtaining business have been considerably less effective than the load funds' far more vigorous, personalized selling drives. Hence the no-load funds have only a small share of total mutual fund assets and shareholder accounts.[166]

E. THE PATTERN OF FEDERAL REGULATION

Although the Investment Company Act is the only Federal statute expressly concerned with investment company regulation, three other Federal securities statutes—the Securities Act of 1933 ("Securities Act"), the Securities Exchange Act of 1934 ("Exchange Act") and the Investment Advisers Act of 1940 ("Advisers Act")—also establish significant regulatory controls over the investment company industry.

[158] For example, T. Rowe Price Associates, Inc., which acts as investment adviser to T. Rowe Price Growth Stock Fund, Inc. (June 30, 1966, assets approximately $224.1 million), the largest fund that has consistently operated on the no-load principle, was a well-established private investment counselor long before it entered the mutual fund business. The aggregate assets that it manages for its nonfund advisory clients are still far in excess of the assets of its fund clients.

[159] These include such New York Stock Exchange firms as Ralph E. Samuel & Co., which acts as investment adviser to Energy Fund, Inc. (June 30, 1966, assets $49 million), Wood, Struthers & Winthrop, the investment adviser to Pine Street Fund, Inc. (June 30, 1966, assets $43 million) and to DeVegh Mutual Fund, Inc. (June 30, 1966, assets $22.1 million), and Lehman Bros., the investment adviser to the One William Street Fund, Inc. (June 30, 1966, assets $231.6 million), the largest of all no-load funds on that date and currently the second largest no-load fund.

[160] Like the load fund advisers, the advisers to the no-load funds benefit from the augmented advisory income—and in some cases brokerage commissions—made possible by the growth of the funds through sales of new fund shares.

[161] Advertisements relating to securities are regulated by the Securities Act of 1933. To prevent the avoidance of the prospectus requirements of the Securities Act, the content of such advertisements is limited in certain respects. Securities Act sec. 2(10)(b) and rule 134 thereunder (17 C.F.R. sec. 230.134). Because of these legal limitations on what can and cannot be said, securities advertisements are usually called "tombstone ads." Since mutual fund shares are securities, advertisements with respect to them must comply with these general rules. Because of the nature of mutual funds, advertisements for their shares are somewhat less restricted than the advertisements for other types of securities. See Securities Act Release No. 4709 (July 14, 1964). Of course, the fund or its adviser could reproduce the entire prospectus as a newspaper or magazine advertisement. (Principal underwriters of load funds have done so.) But this entails considerable cost, and no-load funds have not utilized this means of advertising.

[162] This method of stimulating sales is also available to the load funds (see pp. 50-51, supra), who use it to a greater extent than the no-load funds.

[163] Many investment advisers either refuse or are reluctant to accept clients with assets below a certain stipulated level. Prospective clients whose means are below that level are often advised to buy shares in the no-load fund that the adviser manages. On occasion, nonfund clients recommend the fund's shares to their friends and acquaintances. And some advisers encourage their employees to sell shares of no-load funds under their management; at least one no-load fund adviser reinforces such encouragement by certain monetary inducements.

[164] Some financial writers have directed their readers' attention to the no-load funds.

[165] Like the load funds, most no-load funds seek to induce existing shareholders to purchase new shares with the income dividends and the capital gain distributions that they receive. See pp. 202-204, 215-216 infra. Many no-load funds also offer voluntary accumulation plans.

[166] See p. 52, supra.

4. Economies of size and mutual fund complexes

The relatively low expense and management cost ratios of the companies in the Broad Street complex in part reflect the management economies obtainable when such costs are spread among the assets of the various funds served by the same advisory organization. Since all four companies in the Broad Street complex share Union's operating costs and the compensation of their common officers in proportion to their relative asset size, even the $17 million Whitehall Fund, Inc., the smallest of the four companies, had a relatively low expense ratio—0.31 percent of average net assets in 1965.

The economies of size in the management of the Broad Street complex are not peculiar to internally managed funds. They result from the fact that much of the investment advisory process—the general economic forecasting, the evaluation of particular industries, and the selection of specific stocks—undertaken for the management of one fund's portfolio is also useful in connection with the management of the other funds served by Union. Although the various funds in a single complex usually have somewhat different investment objectives, their portfolios often overlap to a substantial extent.

However, with respect to advisory fees, externally managed funds belonging to large complexes are generally treated as completely separate entities. Although scaled-down fee schedules may reflect to some extent the economies of size in investment company management, they seldom give express recognition to these economies on a complex-wide basis. Of the advisers to the larger externally managed mutual fund complexes, only Keystone Custodian Funds, Inc., Waddell & Reed, Inc., and National Securities & Research Corp. charge advisory fees calculated on the combined assets of more than one fund under their management.

5. Use of brokerage commissions to reduce management costs

The relatively low expense and management cost ratios of the companies in the Broad Street complex also are attributable to the substantial brokerage commissions paid by the companies to Seligman. The officers and directors of the investment companies who are partners in the brokerage firm derive substantial compensation from Seligman in addition to that paid directly to them by the investment companies. This compensation, however, only partly accounts for the relatively lower management costs of these companies. Even if the brokerage commissions received from the four companies by Seligman were considered in evaluating the managerial costs of these companies, such costs would not rise to the level of the advisory fees typically paid to investment advisers by externally managed funds. For example, the 1965 management costs of Broad Street Investing Corp., if increased by 60 percent of the brokerage commissions—the percentage of fund brokerage commissions which executing brokers commonly give to such other brokers as the fund manager may designate [82]—paid to Seligman during that year, would have resulted in a management cost ratio of 0.18 percent of average net assets and an expense ratio of 0.27 percent.

The use of brokerage commissions to pay for investment advisory services is common in the securities industry. Investment advisers who are also broker-dealers often reduce advisory fees charged nonfund clients by a specified portion of the brokerage commissions generated

[82] See pp. 169–172, infra.

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by their nonfund advisory accounts or otherwise take them into account in setting advisory fee rates for nonfund clients. Moreover, the level of the minimum commission rates of the national securities exchanges is affected by the fact that brokerage commissions compensate brokers not only for execution and clearing services but for investment advice and other services customarily provided without extra charge.

In the mutual fund industry, however, brokerage commissions are seldom used to reduce the cost of investment advice. The majority of investment advisers are not affiliated with broker-dealers, and a large portion of the brokerage commissions generated by the mutual funds under their management is used to reward unaffiliated broker-dealers for sales of fund shares.[83]

In some instances the funds' investment advisers are themselves broker-dealers or are affiliates of broker-dealers who receive a large portion of the brokerage commissions generated by these funds. They obtain this business and retain the entire commission because of their relationship to the fund. Nevertheless, the advisory fees charged most of these funds do not reflect a sharing of any portion of the advisers' profits from these revenues. For example, in 1965 the Dreyfus Fund, Inc., paid approximately $2.4 million in brokerage commissions to its affiliate, Dreyfus & Co., a member of the New York Stock Exchange and other national securities exchanges. During that year the fund also paid its investment adviser, a corporation wholly owned by Dreyfus & Co. for most of the year, an advisory fee of $5.1 million at the rate of 0.50 percent of average net assets.[84]

Similarly, since 1959 Insurance Securities Trust Fund has executed all of its portfolio transactions through its investment adviser, Insurance Securities, Inc. ("ISI"). The fund invests only in insurance and bank stocks. These stocks are traded almost entirely in the over-the-counter market where there is no minimum commission schedule. However, the fund is charged commissions within the limits of the New York Stock Exchange minimum commission rate schedule on its portfolio transactions. Despite this, the 1965 MAT fee rates of the fund are the same as those in effect prior to 1959 when ISI did not share in any of the brokerage commissions generated by the fund's portfolio transactions. In its fiscal year ended June 30, 1965, ISI received from the fund $5.4 million in MAT fees and about $1.1 million in brokerage commissions.

In 1965 IDS and Waddell & Reed, Inc.,[85] formed broker-dealer subsidiaries which were admitted to membership in the Pacific Coast Stock Exchange. These subsidiaries execute transactions in securities traded on the exchange for the funds in the complexes. They also do substantial amounts of Pacific Coast Stock Exchange business for brokers who execute orders for the funds on other exchanges. All of the net profits from the operation of its broker-dealer subsidiaries are credited by IDS against the advisory fees paid by the funds. Waddell & Reed, Inc., reduces the advisory fees payable by the funds

[83] See pp. 164-167, infra.
[84] Although the investment adviser became a publicly held company in October 1965, Dreyfus & Co. still serves as regular broker to the fund.
[85] Waddell & Reed, Inc., is adviser to the fourth largest fund complex.

under its management by 50 percent of its broker-dealer subsidiary's net profits.[86]

Both Waddell & Reed, Inc., and IDS act as principal underwriter to the funds under their management. Shares of the IDS funds are distributed exclusively, and those of Waddell & Reed, Inc., almost exclusively, through their own retail selling organizations rather than through independent broker-dealers. While Waddell & Reed, Inc., and IDS utilized brokerage to compensate broker-dealers for supplementary investment advice and other services, they have had little or no occasion to use it as extra compensation for sales of fund shares.

6. Changes in management costs—Internally versus externally managed funds

Although the expenses of MIT and, to a lesser extent, those of the companies in the Broad Street complex include a substantial amount of managerial compensation, their expense and management cost ratios are significantly lower than those of each of the 57 largest externally managed funds. The expense ratios of these funds as shown in table III–3 at page —, supra, ranged from 0.34 percent for Affiliated Fund, Inc.—almost double MIT's 0.18 percent expense ratio—to 1.04 percent for Capital Shares, Inc.

The disparity between the expense ratios of the 57 largest externally managed funds and those of Broad Street Investing Corp. and MIT is primarily due to differences in charges for management services. The median annual advisory fee rate of 0.48 percent for the 57 funds was 4 times or more the 0.10 and 0.11 percent management cost ratios of the companies in the Broad Street complex and the 0.12 percent of ratio of MIT in 1965. Even the 0.26, 0.24, and 0.23 percent advisory fee rates paid respectively by Wellington Fund, Inc., Affiliated Fund, Inc., and Bullock Fund, Ltd., which were the lowest among the 57 funds, amounted to about twice the management cost per dollar of assets managed on behalf of the shareholders of MIT and Broad Street Investing Corp.

As noted, current advisory fees reflect reductions in fee rates made since 1962 against the pressures generated by the settlement of shareholder litigation and the publication of the Wharton Report. A measure of the disparity between advisory fees charged externally managed funds in the absence of these pressures and the management costs of the internally managed funds can be obtained by comparing for a period prior to 1962 the changes in net assets, expense ratios, and management cost ratios of the Broad Street companies and MIT with those of the largest externally managed funds.

[86] Channing Financial Corp., an investment adviser and principal underwriter to a large mutual fund complex, recently purchased an interest in a member firm of the Pacific Coast Stock Exchange but has not indicated to what extent, if any, profits from brokerage business obtainable by virtue of its relationship to the funds under its management will be credited against the advisory fees paid by those funds. A broker-dealer subsidiary of Imperial Financial Services, Inc., adviser-underwriter to a relatively small fund complex, has also obtained membership in the Pacific Coast Stock Exchange, and a portion of the subsidiary's profits will be applied against the advisory fees paid by the fund.

price and to buy the same quantity of the same security at the same price on behalf of a designated buyer. A transaction of this type is known as a "cross". Each side to the transaction pays—and under the exchange rules must pay—a full exchange commission.[74]

A cross is nothing more than the formalization on the exchange floor of a transaction that has previously been negotiated and, as a practical matter, effected elsewhere.[75] A small portion of the resulting commission (usually about 10 percent) goes to the floor broker. The balance is paid to the broker who actually brought the parties together and he, in turn, pays an agreed portion to the over-the-counter dealers and/or regional-only members whom his clients wish to benefit for services unrelated to the transaction.

4. Impact of mutual fund reciprocal and give-up practices

The Special Study observed that "[r]eciprocity, or 'doing business with people who do business with you,' is an accepted custom of the business world in general, and the securities industry is no exception."[76] The Study noted, however, that reciprocal business practices in the allocation of mutual fund brokerage commissions take on a unique character. Although the commissions are generated by fund portfolio transactions and are paid by the funds, their use as extra compensation for sales of fund shares benefits the adviser-underwriters and the retail sellers of fund shares rather than fund shareholders.

Both the Wharton Report and the Special Study questioned whether fund brokerage commissions should be a factor in the competition for sales of fund shares.[77] Since the publication of these reports, the increasing amount of brokerage commissions paid by the rapidly growing mutual fund industry, coupled with the absence of a volume or institutional discount in exchange commission rate schedules, have made reciprocal and give-up practices in the allocation of mutual fund brokerage an even more significant factor in the competition for sales of fund shares. Mutual fund reciprocal and give-up practices also have drawn substantial volume away from the primary markets. Fund managers appear to have placed greater emphasis on the use of brokerage commissions to compete for dealer interest in promoting the sale of their funds' shares, and dealers have become increasingly aware of, and have made greater demands for, the extra sales compensation obtainable from fund brokerage.

(a) Use of brokerage commissions to benefit the funds

(i) *Reducing advisory fees.*—As has been noted, subsidiaries of four adviser-underwriters that maintain their own retail sales forces—among them three of the largest, Investors Diversified Services, Inc., Waddell & Reed, Inc., and Channing Financial Corp.,[78] as well as the smaller Imperial Financial Services, Inc.—are now members of the Pacific Coast Stock Exchange.[79] These subsidiaries execute orders for the funds on the Pacific Coast Stock Exchange.[80] More

[74] In almost all circumstances, all exchanges have required their members to charge each side a full commission.

[75] Crosses are not peculiar to the regional exchanges. They are very important on the NYSE and on the Amex as well.

[76] Special Study, pt. 4, 233.

[77] Wharton Report 33; Special Study, pt. 4, 229, 233-235.

[78] Channing Financial Corp. is a holding company which owns Van Strum & Towne, Inc., the adviser to, and Channing Co., Inc., the underwriter of, the funds in the complex. The broker-dealer which is a member of the Pacific Coast Stock Exchange is a subsidiary of Channing Co., Inc.

[79] Ch. III, pp. 109-110, supra.

[80] The subsidiaries are: Investors Diversified Services, Inc.'s, IDS Securities Co.; Waddell & Reed, Inc.'s, Kansas City Securities Co.; Channing Co., Inc.'s, Emmett A. Larkin Co., Inc., and Imperial Financial Services, Inc.'s, Imperial Securities, Inc.

important, however, they obtain a considerable amount of nonfund business from broker-dealers who are dual members of the Pacific Coast Stock Exchange and other exchanges in return for fund brokerage business on other exchanges, primarily the NYSE. All the net profits of IDS's subsidiary and about 40 to 50 percent of the net profits of Waddell & Reed's and of Imperial Financial Services' subsidiaries have been applied to reduce advisory fees payable by the funds in those complexes.[81]

Widespread emulation by institutional investors of the precedent set by these four complexes could have a marked effect on the economics of the securities industry. Within the framework of the existing commission rate structure it is a method whereby mutual fund shareholders can derive greater benefits than they have heretofore received from fund brokerage commissions. However, among dealer-distributed funds the important role that portfolio brokerage plays in the competition for dealer favor has kept fund managers, with few exceptions, from using exchange memberships to reduce costs of the funds.

Similar competitive factors have also operated against the use, for the benefit of the funds and their shareholders, of regional exchange rules permitting give-ups to any member of the NASD on transactions executed on those exchanges. It would not be inconsistent with those rules for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the funds.[82] Unless and until such procedures become widespread, any adviser-underwriter to a dealer-distributed fund who chose to utilize fund brokerage in this manner would place itself at a disadvantage in competing for the interest of nonmember dealers in selling the fund shares which it distributes.

(ii) *Allocation of brokerage commissions between sales and services.*—The allocation of fund portfolio brokerage to reward dealers for sales of fund shares is frequently justified on the ground that, given the present exchange minimum commission rates, the funds can derive no other benefit from their brokerage. However, the longstanding practice of the Broad Street Complex [83] and the recent actions of IDS, Waddell & Reed, Inc., and Imperial Financial Services, Inc., with respect to their brokerage business belie that assertion. Moreover, as noted above, advisers to most mutual funds allocate varying portions of fund brokerage commissions to pay broker-dealers for pricing services with respect to fund shares, wire facilities, and supplementary investment advisory services. Although funds and their advisory organizations may differ in their need for the services broker-dealers supply in return for brokerage commissions, the need to use brokerage to stimulate the sale of fund shares may tempt a fund adviser to skimp on the allocation of fund brokerage for nonsales services. His interest in promoting sales of fund shares and the importance of brokerage commissions as compensation for such sales make it difficult for an adviser to reach that judgment solely on the basis of the interests of the fund and its shareholders.

[81] Channing Financial Corp. has not yet declared whether and to what extent, the funds managed by it will realize savings from profits made by its subsidiary from exchange commissions.

[82] Alternatively, the fund itself could form a broker-dealer affiliate to which it could direct give-ups. If this course were followed—and no fund now does so—the give-ups would inure to the direct benefit of the fund's shareholders.

[83] See ch. III, pp. 106–108, supra.

fund reciprocal and give-up practices has confirmed and emphasized the problems raised by the Wharton Report and the Special Study. Since this report deals largely with mutual funds, it has discussed use of mutual fund brokerage as additional sales compensation primarily in terms of its impact on funds and their shareholders. It should be emphasized, however, that other institutional investors employ similar techniques. Apart from the purposes of, and impact on, such investors, the Commission is of the view that certain aspects of these practices, particularly the customer-directed give-up, impair the orderly and proper functioning of the securities markets themselves.

(f) Customer-directed give-ups

In the over-the-counter markets, where brokerage costs are subject to negotiation, give-ups of commissions to brokers who perform no necessary function in connection with a transaction have long been recognized as improper and illegal. Give-up practices have been tolerated in the exchange markets only because brokerage costs are fixed by the exchange minimum commission rate schedules. They have become widespread because these schedules have not distinguished between large or small orders and the services sought by or provided to large institutional investors.

Exchange give-up rules may have been originally designed to provide for a reasonable sharing of commissions among those who combined to perform services for customers through traditional correspondent relationships. However, mutual fund give-up practices are wholly inconsistent with this purpose. They permit mutual fund managers to distribute the commissions that the funds pay among securities firms which have nothing to do with the transactions on which the commissions are earned and for services which are of little or no relevance to the interests of the funds' shareholders.

Customer-directed give-ups raise questions as to the propriety of the commission rate schedule itself. Assuming that a minimum commission schedule is necessary and appropriate to effective and efficient operation of an exchange, the commission rate structure should be designed to compensate brokers fairly for the services they perform and to provide equitable treatment for various classes of customers whose use of exchange facilities is basically similar. As existing exchange rules recognize, it should not give direct or indirect discriminatory rebates to particular classes of customers.

Mutual fund give-up practices are inconsistent with these principles. They create rebates not to the brokerage customer, the fund itself, but to its managers who are in a position to direct the fund's brokerage to maximize sales of fund shares. Moreover, the availability of such rebates creates distortions and artificial devices in the securities markets. Give-up practices may facilitate a wider distribution of fund brokerage, but in the process they interfere with the orderly functioning of the markets, the effective execution of customer orders and the channeling of competitive forces for the benefit of public investors, and, as has been noted, they have other undesirable effects on the mutual fund industry.

The give-up is the principal device whereby fund managers are able to channel brokerage commissions to large numbers of dealers in fund shares who do not and are not in a position to perform any useful or necessary function in connection with the transactions on which the

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STATEMENT OF CUSTODIAN

February 28, 1966

To the Shareholders of
AMERICAN INVESTORS FUND, INC.:

We hereby certify that the cash shown on page 16, and the securities listed on pages 20-22, inclusive, of this Prospectus were held by or for us or were in the process of delivery to us, as Custodian for American Investors Fund, Inc., as of the close of business on December 31, 1965.

THE BANK OF NEW YORK
By N. J. MEXTORP
Vice President

OFFICERS AND DIRECTORS

GEORGE A. CHESTNUTT, JR. . . *President and Director*
STANLEY LAW SABEL . . . *Vice President, Secretary and Director*
ELIZABETH SULLIVAN . . . *Treasurer and Director*
JOHN CURRIER . . . . . *Director*
FRANK G. FOWLER, JR. . . . . *Director*
RICHARD W. RADCLIFFE . . . . . *Director*
FRANCIS L. VEEDER . . . . . *Director*
BARBARA DEGAETANI . . . . . *Asst. Treasurer*
EUGENE E. GEARDON . . . . . *Asst. Secretary*

Investment Adviser
AMERICAN INVESTORS CORPORATION

Legal Counsel
CLARK & SUTTON

Custodian and Transfer Agent
THE BANK OF NEW YORK

Independent Accountants
PRICE WATERHOUSE & CO.

American Investors Fund, Inc.

AMERICAN INVESTORS FUND, INC.

Prospectus

American Investors Fund, Inc. is a mutual fund seeking growth of capital through increasing value of the securities in its investment portfolio.

MAY 2, 1966

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Plan, in accordance with the Keogh Act, to create a retirement fund, with the tax benefits provided in the Act, to help provide for the future security of participants. Detailed information and forms available on request.

Systematic Withdrawal Plan

The Systematic Withdrawal Plan is designed primarily to supplement social security and other retirement funds, by periodic payments from investment income and the orderly withdrawal of capital funds. It may provide regular payments for other purposes, such as education or support of dependents. The Plan can be started as soon as you own shares valued at $10,000 or more.

The Fund sends you a check monthly, quarterly or at any interval you designate on the form. Only enough shares are redeemed to meet withdrawals. It should be made clear, since the Fund's objective is growth of investment capital primarily through capital gains rather than from dividends or interest, that periodic payments under this Plan are expected to come primarily from capital sources. Such payments will come first from any net income which may be almost incidental, second from any distributable capital gains and finally, in the event that no capital gains have been distributed in any particular year (for example, 1963), will come as a return of the investor's paid-in capital. Since for some investors capital gains are taxable at lower rates than dividend income, the possible advantage or disadvantage to the individual investor of spending capital gains, rather than income only, should be carefully weighted in the light of his own particular income tax situation.

The Systematic Withdrawal Plan does not impose any special service charge to Plan Members for using this convenience. Bank service charges on withdrawals are paid entirely by the Fund's Investment Adviser.

Under this Plan, dividends and capital gains distributions, if any, are reinvested for the shareholder by The Bank of New York. To the extent that withdrawal payments exceed investment income they, of course, represent return of capital. Since the Periodic Investment Plan provides for accumulation of capital, and the Systematic Withdrawal Plan is for regular payments from capital, the two programs may not be carried on simultaneously by the same investor.

A Systematic Withdrawal Plan may be terminated at any time and the amount of systematic withdrawals may be changed from time to time. Withdrawals may be in any amount of $25 or more. In most circumstances it is wise to limit total yearly withdrawals to not more than $1,200 for each $10,000 of starting value. (This would be $100 per month, $300 per quarter, on an account with a starting value of $10,000.) It should be realized that payments requiring share liquidation reduce the capital invested, and that this occurs more rapidly when Fund share prices are low than when they are high. *A Periodic Investment Plan* can be started now to build up your capital over a period of time prior to establishing a *Systematic Withdrawal Plan* at some future date.

Determination of Net Asset Value

For the purpose of determining the public offering, repurchase or redemption price of shares of the Fund, the net asset value is determined once daily as of the close of business on the New York Stock Exchange, 3:30 P.M. New York time. Securities traded on a national securities exchange are valued at the last sales price prior to such time on the day when the valuation is made. (1) Where there has been no sale of a listed security on the valuation day, and (2) where the security is traded over-the-counter, the security is generally valued at the mean between the bid and asked (or nearest eighth below the mean) pursuant to the provisions of the Fund's Certificate of Incorporation and authority given to the officers by the Board of Directors. The Certificate of Incorporation provides that where there has been no sale of a listed security on the valuation day or where the security is traded over-the-counter, the security is valued at the last current quoted bid price, or at a price not exceeding any current asked price representative of fair market value, where there is no

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Determination of Net Asset Value—(Continued)

such bid price or where such bid price does not appear representative of fair market value, all as determined by the Board of Directors or pursuant to their authority. The Board has given the officers authority (1) where there has been no sale of a listed security on the valuation day, and (2) where the security is traded over-the-counter to value securities at prices not exceeding any current asked price if in their judgment the current bid price does not appear representative of fair market value, such valuation to be between the last current quoted bid price and the last current quoted asked price. Such price is effective for orders received after 2:00 P.M. that day and remains in effect until 2:00 P.M. on the next business day.

The net assets of the Fund are computed by deducting total liabilities from total assets. The net asset value per share is ascertained by dividing the net assets of the Fund by the total number of shares outstanding, exclusive of treasury shares and shares tendered for redemption the redemption price of which has been determined. Adjustments for fractions are made to the nearer cent.

Redemption of Shares

Shareholders have the right to obtain redemption of their shares by the Fund. The Fund is required, within seven days following tender of the shares and demand in writing for redemption, to pay the holder the net asset value per share determined as of the close of business on the day following such presentation of the shares.

Shareholders holding certificates should tender them along with the redemption demand. Shareholders whose shares are held in open accounts with The Bank of New York need only transmit their demand in writing. No signature guarantee is required on the stock certificates or written instructions unless the redemption proceeds are to be paid to someone other than the registered owner of the shares, in which case the guarantee should be by a bank, or trust company in, or having a correspondent in, New York City, or by a member of the New York Stock Exchange.

It is advisable that a shareholder should not send a redemption request directly to the Fund's office as time may be lost which could be saved if the written demand (and tender of certificates, if held) were made directly to the Corporate Agencies Department, The Bank of New York, P. O. Box 1873, New York, N. Y. 10008.

When a shareholder sells his stock, its value may be more or less than its cost, depending upon the market value of the Fund's portfolio. Approximately 32.1% of the net asset value of the shares as of December 31, 1965 represents unrealized appreciation. Net gain on the sale of securities when realized and distributed (actually or constructively) is taxable as capital gain. If the net asset value of shares were reduced below a shareholder's cost by distribution of gain realized on the sale of securities such distribution would be a return of investment though taxable as stated above.

If the Board of Directors shall determine that it is in the best interest of the remaining shareholders, the Fund may pay the redemption price in whole or in part by a distribution of securities from its portfolio, in lieu of cash, taking such securities at the same value used for determining net asset value, and selecting the securities in such manner as the Board of Directors may deem fair and equitable.

In accordance with the Investment Company Act of 1940, redemption privileges may be suspended for any period during which the New York Stock Exchange is closed. Under such Act and as determined by rules and regulations of the Securities and Exchange Commission, redemption privileges may also be suspended for any period during which trading on the New York Stock Exchange is restricted, or an emergency exists as a result of which disposal by the Fund of securities owned by it is not reasonably practicable or it is not reasonably practicable fairly to determine the value of its net assets, or for such other periods as the Commission may by order permit for the protection of the shareholders.

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AMERICAN INVESTORS FUND, INC.

88 Field Point Road, Greenwich, Connecticut 06830
Mail address P. O. Box 2500

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PROSPECTUS, MAY 1, 1968

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THERE IS NO SALES LOAD OR UNDERWRITING COMMISSION.
The Subscription Price is the Net Asset Value Per Share.

THERE IS NO REDEMPTION FEE.
The Redemption Price is the Net Asset Value Per Share.

The Securities and Exchange Commission requires the following statement on the front cover of every Prospectus:

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION, NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

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How to Redeem Shares

All redemption orders must be made in writing. Shareholders whose shares are held in open accounts with The Bank of New York should send their written demand directly to the Bank. The redemption demand must be signed exactly in accordance with the form of registration and the account number should be included to avoid delay. If shares are owned by more than one person, the redemption demand must be signed by all owners exactly as their names appear in the registration. Shareholders holding certificates must tender (deliver) them along with their signed redemption demand. No signature guarantee is required on the stock certificates or on written instructions except, in the case of stock certificates, if redemption proceeds are to be paid to someone other than the registered owner of the shares, the guarantee should be by a bank or trust company in, or having a correspondent in, New York City, or by a member of the New York Stock Exchange.

It is advisable that a shareholder should not send a redemption demand directly to the Fund's office as time may be lost which could be saved if the written demand (and tender of certificates, if held) were made directly to The Bank of New York; Mutual Funds Department; P. O. Box 2943; Church Street Station; New York, N. Y. 10008; Attention: American Investors Fund, Inc. —Redemptions.

Reports to Shareholders

Reports showing the financial condition of the Fund and a list of all security holdings are sent to shareholders each quarter.

Brokerage Commissions

The Fund places orders for transactions in portfolio securities with brokers or dealers providing the most favorable prices and executions available. Speed and accuracy in obtaining market quotations, promptness in execution of orders at minimum commission rates, and prompt reporting of executions are absolutely essential. Among such brokers and dealers, those who have provided helpful information to the Fund, or have assisted in the sale of Fund shares, are given preference (without agreement so to do) in allocating brokerage business, but not at any sacrifice in price or execution. Whether or not such preference were given, the Fund would have to pay the same amount of commissions.

Helpful information obtained from brokerage sources involves quick, accurate quotations and data as to the size of the market; newly obtainable data on money statistics, earnings projections, dividend prospects; probable sellouts, mergers, consolidations, and liquidations; general tape action, with volume of shares, blocks recently traded or to be traded, who the buyers and sellers are believed to be, and other information as to the state of the market at a particular moment.

Brokerage commissions of $387,000 were charged to the Fund on purchases and sales of the Fund's portfolio securities in 1965, $551,668 in 1966, and $1,995,037 in 1967. Of such amounts the Fund allocated approximately $247,000 in 1965, $261,913 in 1966, and $933,966 in 1967, as paid to brokers who provided helpful information, and approximately $140,000 in 1965, $289,755 in 1966, and $1,059,121 in 1967, as paid in connection with the sale of Fund shares. Included in the above amounts allocated for helpful information and sale of Fund shares is brokerage commissions of $18,321 paid in 1965, $33,435 paid in 1966, and $23,936 in 1967 to Vilas & Hickey, the wife of a registered representative of which firm owned 6.3% of the voting and other securities of the adviser. Without knowing what the results would have been absent the helpful information, the Fund knows of no way to determine the approximate value of the helpful information obtained.

Helpful economic information relating to particular investment situations, received by the Fund, is generally unsolicited and offered by a broker to stimulate business. It is the practice of the Fund upon receiving such helpful information from brokerage sources to refer such information to its investment adviser, for verification and opinion as to validity, accuracy and for further research and recommendation as to the desirability of acting upon such information. This involves work by the adviser with related costs. The information itself, for which the Fund allo-

Significant Facts About

AMERICAN INVESTORS FUND, INC.

SECURITIES AND EXCHANGE COMMISSION
RECEIVED
MAY - 4 1971
DIVISION OF CORPORATION FINANCE

88 Field Point Road, Greenwich, Connecticut 06830
Mail Address P. O. Box 2500

PROSPECTUS, APRIL 30, 1971

This Prospectus contains information concerning the Fund's objective, investment policy and other important facts and it is advisable to retain it for future reference.

THERE IS NO SALES LOAD OR UNDERWRITING COMMISSION.
The Subscription Price is the Net Asset Value Per Share.

Minimum Initial Purchase $400; Subsequent Purchases $10.
A 60¢ Handling Charge is Deducted from each Payment.

THERE IS NO REDEMPTION FEE.
The Redemption Price is the Net Asset Value Per Share.

The Securities and Exchange Commission requires the following statement on the front cover of every Prospectus:

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION, NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

How to Redeem Shares—(Continued)

cepted. Shareholders whose shares are held in open accounts with The Bank of New York should send their written demand directly to the Bank. The redemption demand must be signed exactly in accordance with the form of registration and the account number should be included to avoid delay. If shares are owned by more than one person, the redemption demand must be signed by all owners exactly as their names appear in the registration. Shareholders holding certificates must tender (deliver) them along with their signed redemption demand. No signature guarantee is required on the stock certificates or on written instructions except for redemptions exceeding $5,000 or where proceeds are to be paid to someone other than the registered owner of the shares; the guarantee should be by a bank or trust company in, or having a correspondent in New York City, or by a member of the New York, American, Pacific Coast or Midwest stock exchanges.

It is *not* advisable that a shareholder send a redemption demand directly to the Fund's office as time may be lost which could be saved if the written demand (and tender of certificates, if held) were made directly to The Bank of New York; Mutual Funds Department; P. O. Box 11001; Church Street Station; New York, N. Y. 10049; Attention: American Investors Funds, Inc. — Redemptions.

Reports to Shareholders

Reports showing the financial condition of the Fund and a list of security holdings are sent to shareholders each quarter. In addition, mailings making available voluntary low-cost insurance plans are made from time to time at no expense to the Fund.

Brokerage Commissions

The Fund places orders for transactions in portfolio securities with brokers or dealers providing the most favorable prices and executions available. Speed and accuracy in obtaining market quotations, promptness in execution of orders at minimum commission rates, and prompt reporting of executions are absolutely essential. Among such brokers and dealers, those who have provided helpful information to the Fund, or have assisted in the sale of Fund shares, are often given preference (without agreement so to do) in allocating brokerage business, but not at any sacrifice in price or execution. Regardless of such preference, the Fund will endeavor to place orders so as to maximize total proceeds on sales of portfolio securities and minimize the total cost on purchases. In connection with Over-the-Counter transactions, the Fund deals directly with market makers, except in instances where the Fund believes better prices and executions are available elsewhere.

Helpful information obtained from brokerage sources involves quick, accurate quotations and data as to the size of the market; data on money statistics, earnings projections, dividend prospects; probable sellouts, mergers, consolidations, and liquidations; general tape action, with volume of shares, blocks recently traded or to be traded, who the buyers and sellers are believed to be, and other information as to the state of the market at a particular moment.

Brokerage commissions of $3,122,160 were charged to the Fund on purchases and sales of the Fund's portfolio securities in 1968, $2,489,281 in 1969 and $2,059,234 in 1970. Of such amounts the Fund allocated approximately $2,022,457 in 1968, $1,196,059 in 1969 and $1,108,667 in 1970 to brokers who provided helpful information, and approximately $1,099,703 in 1968, $1,293,222 in 1969 and $950,567 in 1970 for help in the sale of Fund shares. Included in the above amounts allocated for helpful information and sale of Fund shares are brokerage commissions of $44,537 in 1968, $39,110 in 1969 and $83,308 in 1970 to Vilas & Hickey (the wife of a registered representative of which firm owned 6.3% of the voting and other securities of the adviser). Without knowing what the results would have been absent the helpful information, the Fund knows of no way to determine the approximate value of the helpful information obtained. See under "Investment Policy" for portfolio turnover during 1968-1970, inclusive.

American Investors Fund, Inc.

NOTICE AND PROXY STATEMENT

Notice of Annual Meeting of Shareholders
to be held July 18, 1972

To the Shareholders:

PLEASE TAKE NOTICE that the annual meeting of the shareholders of AMERICAN INVESTORS FUND, INC. will be held on Tuesday, July 18, 1972, at 10:30 o'clock A.M. in the New Orleans Room at the Showboat Inn, 500 Steamboat Road, Greenwich, Connecticut for the following purposes:

1. to elect directors;
2. to consider and act upon a proposal to approve the terms of a new Investment Advisory Agreement, as set forth in the enclosed Proxy Statement;
3. to ratify or reject the selection of Price Waterhouse & Co. as auditors of the Fund for the year 1972; and
4. to transact such other business as may properly be brought before the meeting.

Only shareholders of record at the close of business on May 30, 1972 are entitled to notice of, and to vote at, the Meeting.

Shareholders are requested to specify their choices, date and sign the enclosed proxy and return in the reply envelope to which no postage need be affixed if mailed in the United States.

By order of the Board of Directors,

DOUGLAS M. CRAM,
Secretary.

June 6, 1972

PROXY STATEMENT

This Proxy Statement is furnished to shareholders of AMERICAN INVESTORS FUND, INC. in connection with the solicitation of proxies to be used at the annual meeting of shareholders of the Fund. This meeting will be held on Tuesday, July 18, 1972, at the time and place and for the purposes set forth in the accompanying Notice of Annual Meeting of Shareholders. The solicitation is made by the management of the Fund and the cost of solicitation will be borne by the Fund.

If the enclosed form of proxy is executed and returned, it may nevertheless be revoked at any time before it is exercised. The shares represented by the proxy, if not limited to the contrary, will be voted for the election of directors and in favor of proposals 2 and 3. If a choice is indicated, the shares will be voted in accordance with the specifications so made.

The number of shares of Capital Stock of the Fund issued and outstanding, as of May 30, 1972, was 37,186,380. Each share is entitled to one vote. Only shareholders of record at the close of business on May 30, 1972 will be entitled to vote at the meeting.

Election of Directors

The proxy will be voted for the election of the following directors to hold office until the next annual meeting and until their respective successors have been elected and qualified:

Name, Principal Occupation or Employment	Year First Became Director	Shares Owned Beneficially 5/8/72
GEORGE A. CHESTNUTT, JR., President of the Fund; President of Chestnutt Corporation (Investment Adviser to the Fund)	1957	27,000*
JOHN CURRIER, President, Formfit Rogers Co., women's apparel manufacturer	1962	847
FRANK G. FOWLER, JR., Secretary and Treasurer of Fowler Engineering Corp., municipal engineers and title surveyors	1962	278
WARREN K. GREENE, Vice President of the Fund; Vice President of Chestnutt Corporation; President of Chestnutt Management Corporation, investment counseling subsidiary of Chestnutt Corporation	1966	100
STANLEY LAW SABEL, Employee of Chestnutt Corporation	1957	5,980*
WILLIAM A. SEMMES, Retired	1969	100
EUGENE A. ULRICH, Assistant Controller, American Airlines	1971	180
FRANCIS L. VEEDER, Retired, managing own investments	1962	406

NOTE:

* Including 8,000 shares owned by Mr. Chestnutt's wife, Sara M. Chestnutt, and 2,326 shares owned by Mr. Sabel's wife, Elizabeth C. Sabel, including two trusts of which she is trustee and has reversionary interests. No person owns of record or beneficially more than one per cent of the outstanding voting securities of the Fund.

All of the nominees are now Directors of the Fund, elected by a vote of security holders at the ..t meeting, held on August 3, 1971, for which proxies were solicited. In the event that any of the ..ve nominees should be unable to serve by reason of death or other unexpected occurrence, those ..ho shall act as proxies will vote the proxy according to their best judgment.

During 1971 the Fund paid remuneration, including directors' fees, to its directors and officers aggregating $15,750; also Sutton, Sabel and Schupp, of which Stanley Law Sabel, a director of the ..nd, is a partner, received $12,000 during such period for legal services.

Securities of the Investment Adviser

The Investment Adviser, Chestnutt Corporation, has outstanding $140,800 of 6% Serial Income ..onds and 188,592 shares of Common Stock as of May 31, 1972. George A. Chestnutt, Jr. owns ..,885 shares (47.1%) of Common Stock. Stanley Law Sabel owns $24,000 principal amount (17.0%) of Bonds and 30,869 shares (16.4%) of Common Stock. George A. Chestnutt, Jr. and Stanley Law Sabel as trustees of a trust created on April 4, 1965, for members of Mr. Chestnutt's family and of which he is remainderman, hold $34,000 principal amount (24.2%) of Bonds. John Currier owns $2,800 principal amount (2.0%) of Bonds, and 2,200 shares (1.2%) of Common Stock. Warren K. Greene owns 915 shares (0.5%) of Common Stock. G. Peter Mumbach owns 237 shares (0.1%) of Common Stock. Vilas & Hickey received $86,481 in brokerage commissions from the Fund in 1971, and the wife of a registered representative of such firm owns $8,000 principal amount (5.7%) of Bonds and 11,970 shares (6.3%) of Common Stock. In addition, pursuant to the Chestnutt Corporation Stock Option Plan adopted in 1969, the following officers of the Fund hold options covering the shares set forth after their names: Warren K. Greene (4,000), G. Peter Mumbach (500), and Douglas M. Cram (200). As owners of securities of the Investment Adviser, Chestnutt Corporation, George A. Chestnutt, Jr., Stanley Law Sabel, John Currier, Warren K. Greene, G. Peter Mumbach and Douglas M. Cram have an interest in the Investment Adviser and in the proposed new Investment Advisory Agreement referred to under "Approval of the Terms of New Advisory Agreement."

Information Pertaining to Investment Adviser and Investment Advisory Agreement

The Fund entered into its present advisory agreement with Chestnutt Corporation, 88 Field Point Road, Greenwich, Connecticut, following approval of the agreement by the shareholders at the Annual Meeting held on August 3, 1971. George A. Chestnutt, Jr. is President and principal executive officer of Chestnutt Corporation and Warren K. Greene is Vice President. George A. Chestnutt, Jr., Stanley Law Sabel, Warren K. Greene and Clendon H. Lee are the Directors of Chestnutt Corporation; the address of Messrs. Chestnutt, Sabel and Greene is 88 Field Point Road, Greenwich, Connecticut; and the principal occupation of Clendon H. Lee is general practice of law.

The advisory agreement is in effect for two years from September 1, 1971, unless cancelled by either party on 60 days' notice.

The Fund's Investment Adviser, Chestnutt Corporation, owns and occupies an office building at 88 Field Point Road, Greenwich, Connecticut, where it provides office space and related services to the Fund pursuant to the Investment Advisory Agreement between the Fund and Chestnutt Corporation. Chestnutt Corporation was incorporated in the State of Connecticut in 1965, and succeeded the prior Investment Adviser of the Fund in 1966. However, personnel and equity ownership of Chestnutt Corporation is substantially similar to that of its predecessors, who have managed and promoted the Fund since its inception in 1957. Chestnutt Corporation is the publisher of American Investors Service, a technical weekly market service. Chestnutt Management Corporation, a wholly-owned subsidiary of Chestnutt Corporation, manages individual and institutional investment accounts.

The Investment Advisory Agreement provides that it cannot be amended, assigned or pledged and shall automatically and immediately terminate in the event it is amended, assigned or pledged. The Agreement provides for fees, calculated on the basis of net assets, determined quarterly which on an annual basis amounts to 0.8% on the first $50,000,000 of net assets of the Fund, 0.6% on the next $50,000,000, 0.4% on the next $200,000,000, 0.35% on the next $200,000,000, and 0.3% on net assets in excess of $500,000,000. The annual fee is not more than an amount which will result in total charges per annum to the Fund, inclusive of the fee of the Investment Adviser (but exclusive of interest and taxes), of 1% of the value of the Fund's average monthly net assets for any year. The Adviser is required to render research, statistical, and advisory services to the Fund; to make specific recommendations based on the Fund's investment requirements; to provide office space and all necessary light, heat, telephone service and office equipment; and stationery, stenographic, clerical, mailing and messenger services in connection with such office; and to pay the salaries of all of the Fund's executives, and to pay all promotional, travel, and entertainment expenses relating to Fund sales. For 1971, $1,243,301 was paid by the Fund to its Investment Adviser, Chestnutt Corporation.

As a result of amendments to the Investment Company Act enacted by Congress in 1970, the present advisory agreement will continue in effect for two years from September 1, 1971 and thereafter only so long as it is approved at least annually by a majority of the Directors who are neither parties to such contract nor "interested persons" (as defined in the Investment Company Act of 1940, as amended) of any such party, and either (a) the Board of Directors of the Fund or (b) by a vote of holders of a majority of the outstanding shares of the Fund.

Approval of the Terms of New Advisory Agreement

The new Investment Advisory Agreement is identical with the Agreement described above except that it provides for an initial two year term commencing on September 1, 1972. If approved

by a majority vote of shareholders, the new Agreement will be substituted for the Agreement currently in effect. The proposed new Agreement appears as pages 13-16 of this Proxy Statement. Approval of the new Investment Advisory Agreement could, to the extent deemed appropriate by defense counsel, be used as a defense in the Fogel Litigation described in this Proxy Statement at pages 7 and 8.

To be adopted, the new Agreement must be approved by a majority of directors who are not parties to such Agreement or interested persons of any such party and must be authorized by a vote of a majority of the outstanding shares of the Fund; by definition contained in the Investment Company Act of 1940 this means a vote of (a) holders of 67% or more of the shares of the Fund present if holders of more than 50% of the outstanding shares of the Fund entitled to vote at the meeting are present in person or by proxy, or (b) holders of more than 50% of the outstanding shares of the Fund entitled to vote at the meeting, whichever is less.

Ratification of Selection of Independent Accountants

The Board of Directors has selected Price Waterhouse & Co., independent accountants, as auditors of the Fund for the year 1972, subject to ratification or rejection at this annual meeting.

Price Waterhouse & Co. has no other relationship with the Fund except as independent accountants. The employment of Price Waterhouse & Co. is conditioned upon the right of the Fund, by vote of holders of a majority of the outstanding stock at any meeting called for the purpose, to terminate such employment forthwith without any penalty.

Other Business

The management does not know of any other business which will be presented for action at the meeting. If business other than the above mentioned is brought before the meeting, those who shall act as proxies at the meeting will vote the proxy according to their best judgment.

Brokerage Commissions

The Fund's investment policies have resulted in a higher than average rate of portfolio turnover, [illegible]% in 1969, 93.1% in 1970 and 73.3% in 1971 exclusive of all U. S. Government securities and all other securities whose maturities at the time of acquisition were one year or less. The Fund places orders for transactions in portfolio securities with brokers or dealers providing the most favorable prices and executions available. Speed and accuracy in obtaining market quotations, promptness in execution of orders at minimum commission rates, and prompt reporting of executions are absolutely essential. Among such brokers and dealers, those who have provided helpful information to the Fund, or have assisted in the sale of Fund shares, are often given preference (without agreement so to do) in allocating brokerage business, but not at any sacrifice in price or execution. Regardless of such preference, the Fund will endeavor to place orders so as to maximize total

proceeds on sales of portfolio securities and minimize the total cost on purchases. In connection with Over-the-Counter transactions, the Fund deals directly with market makers, except in instances where the Fund believes better prices and executions are available elsewhere.

Helpful information obtained from brokerage sources involves quick, accurate quotations and data as to the size of the market; data on money statistics, earnings projections, dividend prospects; probable sellouts, mergers, consolidations, and liquidations; general tape action, with volume of shares, blocks recently traded or to be traded, who the buyers and sellers are believed to be, and other information as to the state of the market at a particular moment.

On February 2, 1972 the Securities and Exchange Commission issued its statement on the "Future Structure of the Securities Markets" containing recommendations which, if implemented, may result in the termination of the Fund's allocation of brokerage for assistance in the sale of Fund shares. To accomplish this the Commission has sent a letter to the National Association of Securities Dealers setting forth the Commission's views and requesting that the National Association of Securities Dealers direct its members to discontinue the use of reciprocal portfolio brokerage for the sale of investment company shares. In the event that brokerage for assistance in the sale of fund shares is eliminated, the Fund may have to consider a sales charge on new share purchases.

Brokerage commissions of $2,489,281 were charged to the Fund on purchases and sales of the Fund's portfolio securities in 1969, $2,059,234 in 1970 and $1,657,690 in 1971. Of such amounts the Fund allocated approximately $1,196,059 (48.0%) in 1969, $1,108,667 (53.8%) in 1970 and $882,853 (52.9%) in 1971 to brokers who provided helpful information, and approximately $1,293,222 (52.0%) in 1969, $950,567 (46.2%) in 1970 and $784,837 (47.1%) in 1971 for help in the sale of Fund shares. Included in the above amounts allocated for helpful information and sale of Fund shares are brokerage commissions of $39,110 (1.6%) in 1969, $83,308 (4.0%) in 1970 and $86,481 (5.2%) in 1971 to Vilas & Hickey (the wife of a registered representative of which firm owned 6.3% of the voting and other securities of the adviser).

The Fund continues to give preference in the allocation of brokerage business to such brokers and dealers who have provided helpful information or who have assisted in selling Fund shares. Officers of the Fund are primarily responsible for the selection of investments and the placing of orders. Following are tabulations for 1970 and 1971 showing the 10 brokerage firms which received the greatest amount of brokerage commissions.

1970

Broker	Gross Commissions
Jesup & Lamont	$122,648
Goldman, Sachs & Co.	122,263
Pershing & Co.	97,616
Bear, Stearns & Co.	97,035

1970—(Continued)

Broker	Gross Commissions
Merrill Lynch, Pierce, Fenner & Smith, Inc. ..	89,266
Thomson & McKinnon, Inc.	89,216
Saxton (G.A.) & Co., Inc.	83,853
Vilas & Hickey	83,308
Chartered New England Corporation	80,716
Harris, Upham & Co.	63,549

1971

Eastman Dillon, Union Securities & Co.	$119,684
R. E. Hart & Co. Incorporated	103,612
Halle & Stieglitz Inc.	87,819
Vilas & Hickey	86,481
Thomson & McKinnon, Auchincloss, Inc.	67,756
Merrill Lynch, Pierce, Fenner & Smith, Inc. ..	65,648
Jesup & Lamont	53,312
Harris, Upham & Co. Incorporated	44,339
Pershing & Co.	41,715
Dominick & Dominick, Incorporated	41,345

Without knowing what the results would have been absent the helpful information, the Fund knows of no way to determine the approximate value of helpful information obtained. Helpful economic information relating to particular investment situations, received by the Fund, is generally unsolicited and offered by a broker to stimulate business. It is the practice of the Fund upon receiving such helpful information from brokerage sources to refer such information to its investment adviser, for verification and opinion as to validity, accuracy, and for further research and recommendation as to the desirability of acting upon such information. This involves work by the adviser with related costs, and to the extent such information can be utilized, such information can aid the Adviser in obtaining better investment performance for the Fund. The information itself, for which the Fund allocated approximately $41,145 in 1969 and $4,539 in 1970, aided the adviser in making investment decisions.

Litigation

Directors of the Fund and the adviser, Chestnutt Corporation, are defendants and the Fund is a nominal defendant in two derivative actions brought in January, 1967, and July, 1968, respectively, in the United States District Court for the Southern District of New York (67 Civ. 60 and 68 Civ. 2685) by joint shareholders, Rosalind Fogel and Gerald Fogel, holders of 280 and a fraction shares. The first action alleges, among other things, that the investment advisory fees are excessive

and that by reason of brokerage commissions (which were the standard minimum stock exchange commissions) of Jesup & Lamont, The Fund of Funds Ltd. in effect received a rebate and thus purchased shares of the Fund at prices different from the public offering described in the Prospectus. The action is for an injunction and seeks to have the directors of the Fund, the management corporation, The Fund of Funds and its affiliate I.O.S. Ltd. (S.A.), and Jesup & Lamont restore to the Fund the brokerage commissions paid to Jesup & Lamont and to have such defendants account for, and pay to, the Fund the advisory fees received by them since 1963. The second action alleges, among other things, that the management corporation, by the use of reciprocal brokerage, give-ups, and mark-ups and mark-downs in over-the-counter transactions, received compensation in excess of the amounts provided for in the investment advisory contract, and that such alleged excess compensation should be recaptured for the benefit of the Fund and seeks an injunction in addition to damages for failure to secure such recapture. No recovery is sought from the Fund, in either action. Nevertheless, this litigation will result in additional expenses to the Fund by way of legal services and by way of probable reimbursement of expenses incurred by Officers and Directors in defending the suit. It is not possible at this time to anticipate the total amount of such expenses. An answer has been filed by defendants in each of these actions denying all allegations of wrongdoing and containing numerous affirmative defenses. In the opinion of Sutton, Sabel & Schupp, Counsel for the Investment Adviser and Messrs. Rogers Hoge & Hills, Special Counsel retained by the Investment Adviser, the suits have no merit.

On September 24, 1970, a suit was filed (now, Blank, et al. v. Talley Industries, et al., Southern District of New York, 70 Civ. 4144) against 25 defendants, including the Fund, claiming that Talley Industries, Inc., its accountants, Peat, Marwick, Mitchell & Co., Smith, Barney & Co., Inc., Lehman Brothers, M. Kimelman & Co., the Fund, and a number of individuals (including the Fund's President) violated securities laws and common law duties in connection with the merger of General Time Corporation into Talley Industries, Inc. and transactions in stock of General Time Corporation. An answer has been filed on behalf of the Fund and its President denying all allegations of wrongdoing and containing numerous affirmative defenses. The Fund has been advised by Rogers Hoge & Hills, Special Counsel retained for this litigation that valid defenses exist to the claims and the suit against the Fund and its President is without merit. However, the Fund will incur expenses in connection with the defense of this suit and any indemnification of its President in an amount which cannot be ascertained at this time.

By order of the Board of Directors,

GEORGE A. CHESTNUTT, JR.
President

Dated: June 6, 1972

The following statement is not a balance sheet of American Investors Fund, Inc., but is a consolidated balance sheet of the investment adviser, Chestnutt Corporation, as required to be included in the Proxy Statement by Rule 270.20a-2(a)(9) of the regulations issued by the Securities and Exchange Commission under the Investment Company Act of 1940.

CHESTNUTT CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET
December 31, 1971

ASSETS

CURRENT ASSETS:	
Cash	$ 8,427
Marketable securities, at cost which approximates market value	187,616
Accounts receivable:	
American Investors Fund, Inc. (Note 2)	695,195
Other	69,744
	834,939
Prepaid expenses	17,395
Total current assets	848,377
PROPERTY AND EQUIPMENT, at cost (Notes 4 and 6):	
Land	288,977
Office building	847,539
Leasehold improvements	11,800
Furniture, fixtures and equipment	267,698
	1,216,014
Less—Accumulated depreciation and amortization	398,835
	817,179
FUTURE INCOME TAX BENEFITS, arising from excess of book over tax depreciation	38,705
GOODWILL, COPYRIGHTS, METHODS, CALCULATIONS AND PROCEDURES	
	$1,404,262

LIABILITIES AND SHAREHOLDERS' EQUITY

CURRENT LIABILITIES:	
Current portion of long-term debt (Note 4)	$ 24,108
Note payable to bank	25,000
Accounts payable	55,569
Accrued liabilities	41,770
Estimated taxes on income (Note 3)	137,041
Deferred management advisory fees and service subscriptions	61,634
Total current liabilities	345,122
LONG-TERM DEBT (Note 4)	341,663
SHAREHOLDERS' EQUITY (Note 5):	
Common Stock—no par value:	
250,000 shares authorized, 189,000 shares issued	14,463
Retained earnings	711,174
	725,637
Less—Cost of 403 shares of common stock in treasury	8,160
	717,477
CONTINGENT LIABILITIES (Note 7)	
	$1,404,262

CHESTNUTT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED BALANCE SHEET

Note 1—PRINCIPLES OF CONSOLIDATION:

The consolidated balance sheet includes the accounts of Chestnutt Corporation and its subsidiaries, all of which are wholly owned. All intercompany accounts and transactions have been eliminated in consolidation.

Note 2—INVESTMENT ADVISORY AGREEMENT WITH AMERICAN INVESTORS FUND, INC.:

The advisory fee ($1,243,301 in 1971) from American Investors Fund, Inc., with which the principal officers of the corporation and three of the four directors are affiliated, was earned pursuant to an investment advisory agreement. The investment advisory agreement includes, among other things, a provision for the payment by the Fund of a fee determined on the basis of the net assets of the Fund at the end of each quarter as follows:

Annual Rate	Net Assets
0.8%	First $ 50 million
0.6	Next $ 50 million
0.4	Next $200 million
0.35	Next $200 million
0.3	Over $500 million

The corporation has agreed to refund each year any amount by which total expenses of the Fund, exclusive of taxes and interest, exceed 1% of average monthly net assets of the Fund for such year. No refund has been required under this provision.

Note 3—INCOME TAX:

At December 31, 1971 there is approximately $179,000 available, through 1975, to offset future realized capital gains for federal income tax purposes.

Note 4—LONG-TERM DEBT:

Long-term debt at December 31, 1971, is summarized as follows:

	Annual Interest Rate	Amount
Mortgages:		
Quarterly payments of $5,000, including interest, required to September 1, 1980, when remaining principal of $111,212 becomes payable. Secured by corporate office property (book value—$563,014)	5½%	$204,971

CHESTNUTT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED BALANCE SHEET—(Continued)

	Annual Interest Rate	Amount
Annual principal installment of $5,000 required. Secured by property adjacent to corporate office property (book value—$30,000)	5¼%	20,000
		224,971
Serial income bonds due in annual principal amounts of $10,200 until 1976 when the balance of $100,000 is payable	6%	140,800
		365,771
Less—Amounts due within one year		24,108
		$341,663

The payment of interest on the serial income bonds in any year may be limited by the corporation to the net income of the preceding year. However, in the event of nonpayment, interest is cumulative to the extent of 18% of the principal amount of the bonds outstanding. Interest is payable annually on February 1 and has been paid through February 1, 1972.

Note 5—STOCK OPTIONS:

At December 31, 1971 under a qualified stock option plan, options to purchase 8,900 shares were outstanding at prices of $20.00 per share (4,900 options expiring in March 1976) and $25.00 per share (4,000 options expiring in February 1975). No options were exercised in 1971 and at December 31, 1971 options to purchase 100 shares were available for future grant.

Note 6—COMMITMENTS:

The corporation leases office space for the subscription and mailing department at an annual rental of $7,200. The lease agreement expires in April 1974.

The corporation has entered into an agreement with a former officer providing for monthly payments of $2,500 through February 1973 and at the annual rate of $5,000 from March 1973 through February 1978. The agreement also provides, under certain conditions, for the payments to be made to the wife of the former officer in the event of his death or incapacity.

Note 7—CONTINGENT LIABILITIES:

The corporation and one of its subsidiaries, Chestnutt Management Corporation, are defendants in three civil actions alleging, in general, failure to properly manage customers' accounts. In the opinions of the corporation's General Counsel and Special Counsel retained for these matters the results of such litigation should not have a material adverse effect on the consolidated financial position of the corporation.

See additional matters of litigation under "Litigation" on page 7 of this Proxy Statement.

OPINION OF INDEPENDENT ACCOUNTANTS

To the Board of Directors
and Shareholders of Chestnutt Corporation

In our opinion, the accompanying consolidated balance sheet presents fairly the financial position of Chestnutt Corporation and its subsidiaries at December 31, 1971, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. This opinion is based on an examination which was made by us in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

PRICE WATERHOUSE & CO.

Stamford, Connecticut
March 21, 1972

EXHIBIT I

INVESTMENT ADVISORY AGREEMENT
between
AMERICAN INVESTORS FUND, INC.
and
CHESTNUTT CORPORATION

AGREEMENT made as of September 1, 1972, by and between AMERICAN INVESTORS FUND, INC., a corporation organized and existing under the laws of the State of New York (herein called the "Corporation") and CHESTNUTT CORPORATION, a corporation organized and existing under the laws of the State of Connecticut (herein called the "Investment Adviser").

WHEREAS, the Corporation is engaged in business as an open-end management investment company, and is registered under the Investment Company Act of 1940, and

WHEREAS, the Investment Adviser is engaged in the business, among other things, of rendering research, statistical, and advisory services to investors, and is registered under the Investment Advisors Act of 1940.

NOW, THEREFORE, in consideration of the premises and of the mutual promises hereinafter set forth, the parties hereto agree as follows:

1. The Corporation hereby retains the Investment Adviser to render research, statistical and advisory services to the Corporation, and to assist and guide the officers and directors of the Corporation in the investment administration of its resources, so long as this agreement shall remain in effect.

2. The Investment Adviser hereby accepts such retainer and agrees to render such services to the best of its ability.

3. The Corporation will, from time to time, deliver to the Investment Adviser detailed statements of the investments and resources of the Corporation and information as to its investment problems.

4. The Investment Adviser shall, from time to time, to the extent reasonably required in the conduct of the business of the Corporation and upon its request, make available to the Corporation research, statistical, and advisory reports and charts upon the industries, businesses, corporations, and securities as to which such requests shall be made, whether or not the Corporation shall at the time have any investment in such industries, businesses, corporations, or securities.

5. The Investment Adviser shall, from time to time, taking into consideration the investment requirements of the Corporation, recommend to the Corporation that it adopt specified investment

policies, or that it purchase, sell, retain, or exchange designated securities; and the Corporation, acting on such recommendations, may, but shall not be required to, adopt such policies or purchase, sell, retain, or exchange such securities.

6. The officers and advisory personnel of the Investment Adviser shall be available at all times upon reasonable notice for consultation with the directors and officers of the Corporation in connection with any of the Corporation's investment problems.

7. The Investment Adviser shall furnish to the Corporation such office space as may be necessary for the suitable conduct of the Corporation's business and all necesary light, heat, telephone service, office equipment and stationery and stenographic, clerical, mailing and messenger service in connection with such office; and pay the salaries of all of the Fund's executives, and pay all promotional, travel, and entertaining expenses relating to Fund sales.

8. The Investment Adviser shall not be liable for any loss sustained by reason of the adoption of any investment policy or the purchase, sale, or retention of any security on the recommendation of the Investment Adviser, whether or not such recommendation shall have been based upon its own investigation and research or upon investigation and research made by any other individual, firm, or corporation, if such recommendation shall have been made and such other individual, firm, or corporation shall have been selected with due care and in good faith; but nothing herein contained shall be construed to protect the Investment Adviser against any liability to the Corporation or its security holders by reason of wilful misfeasance, bad faith, or gross negligence in the performance of its duties or by reason of its reckless disregard of its obligations and duties under this Agreement.

9. The Corporation agrees to pay to the Investment Adviser and the Investment Adviser agrees to accept as full compensation for all services rendered by the Investment Adviser hereunder for each of the Corporation's fiscal quarters on the last day of each quarter, a fee in an amount determined by applying the following quarterly rates to the value of the Corporation's net assets at the end of each calendar quarter:

Quarterly Rate	Equivalent Annual Rate	Net Assets of the Corporation
0.2 of 1%	0.8 of 1%	on the first $ 50 million
0.15 of 1%	0.6 of 1%	on the next $ 50 million
0.1 of 1%	0.4 of 1%	on the next $200 million
0.0875 of 1%	0.35 of 1%	on the next $200 million
0.075 of 1%	0.3 of 1%	on net assets in excess of $500 million

provided, however, that the annual fee of the Investment Adviser shall not be more than an amount which, when added to the other charges of the Corporation (exclusive of interest and taxes) shall result in total charges per annum to the Corporation inclusive of the fee of the Investment Adviser (but exclusive of interest and taxes) of 1% of the value of the Corporation's average monthly net assets for any year. For the first quarter in which this Agreement shall be in effect, the fore-

going computations shall be made as if this Agreement was in effect for the entire quarter. For the quarter and the year in which this Agreement terminates, there shall be an appropriate proration on the basis of the number of days that this Agreement is in effect during the quarter and the year respectively. If, pursuant to the Certificate of Incorporation of the Corporation, the net assets are not required to be determined on any particular business day, then for the purpose of the foregoing computations, the net assets last determined shall be deemed to be the net assets as of the close of business on that day.

10. The Investment Adviser agrees that it shall not take any long or short position in the stock of the Corporation but this prohibition shall not:

(a) prevent the Investment Adviser, acting as or for the distributor of the stock of the Corporation, from purchasing shares of such stock, if orders to purchase such shares are placed by the distributor upon receipt of purchase orders for such shares and are not in excess of the purchase orders received by the distributor;

(b) prevent the Investment Adviser, acting as or for a distributor of the stock of the Corporation, from maintaining a market for such stock in the capacity of agent for the Corporation; or

(c) prevent the purchase by or for the Investment Adviser of shares of the stock of the Corporation at the price at which such shares are available to the public at the moment of purchase; provided that such purchase be made for investment purposes only.

11. This agreement shall remain in effect for a period of two years from the date hereof unless sooner terminated as hereinafter provided. This agreement shall continue in effect from year to year thereafter, subject to the provisions for termination and all of the other terms and conditions hereof, but only so long as such continuation shall be specifically approved at least annually by a majority of Directors who are neither parties to such contract nor "interested persons" of any such party, and either (a) the Board of Directors of the Fund or (b) by a vote of holders of a majority of the outstanding shares of the Fund.

12. Nothing in this agreement shall prevent the Investment Adviser or any director, officer or employee thereof from acting as Investment Adviser for any other person, firm, or corporation and shall not in any way limit or restrict the Investment Adviser or any of its directors, officers or employees from buying, selling or trading in any securities for its or their own accounts or for the accounts of others for whom it or they may be acting.

13. This agreement cannot be amended, transferred, assigned, sold or in any matter hypothecated or pledged (herein called "amended, assigned or pledged"); in the event of cancellation or expiration of this agreement or other management contract, no new management contract shall become effective without the affirmative vote of holders of a majority of the shares of the Fund. This agreement shall automatically and immediately terminate in the event it is amended, assigned or pledged.

14. This agreement may be terminated (a) by the Corporation, upon sixty (60) days' notice in writing to the Investment Adviser without the payment of any penalty, provided such termination be authorized by resolution of the Board of Directors of the Corporation or by vote of holders of a majority of the shares of the Fund; and (b) by the Investment Adviser, upon sixty (60) days' notice in writing to the Corporation, likewise without penalty.

15. For the purpose of this agreement, the "affirmative vote of holders of a majority of the shares of the Fund" means the affirmative vote, at a duly called and held meeting of shareholders of the Fund, (a) of the holders of 67% or more of the shares of the Fund present (in person or by proxy) and entitled to vote at such meeting, if the holders of more than 50% of the outstanding shares of the Fund entitled to vote at such meeting are present in person or by proxy, or (b) of the holders of more than 50% of the outstanding shares of the Fund entitled to vote at such meeting, whichever is less."

For the purposes of this agreement, "interested person" shall have the meaning defined in the Investment Company Act of 1940, as in force at the time, or in any act amendatory thereof or substitution therefor, as in force at the time.

For the purposes of this agreement, "assignment" shall have the meaning defined in the Investment Company Act of 1940, as in force at the time, or in any act amendatory thereof or in substitution therefor, as in force at the time.

IN WITNESS WHEREOF, the parties hereto have caused this agreement to be duly executed the day and year first above written.

AMERICAN INVESTORS FUND, INC.

By .....
President

Attest:

.....
Secretary

CHESTNUTT CORPORATION

By .....
President

Attest:

.....
Secretary

A51000 811-783-2 with signature of accountant Orig

American Investors Fund, Inc.

NOTICE AND PROXY STATEMENT

Notice of Annual Meeting of Shareholders to be Held July 15, 1969

To the Shareholders:

PLEASE TAKE NOTICE that the annual meeting of the shareholders of AMERICAN INVESTORS FUND, INC. will be held on Tuesday, July 15, 1969, at 10:30 o'clock A.M. in the Commodore Room at the Showboat Inn, 500 Steamboat Road, Greenwich, Connecticut for the following purposes:

1. to elect directors;
2. to consider and act upon a proposal to approve the terms of a new Investment Advisory Agreement, as set forth in the enclosed Proxy Statement;
3. to consider and act upon a proposal to ratify the selection of Price Waterhouse & Co. as auditors of the Fund for the year 1969; and
4. to transact such other business as may properly be brought before the meeting.

Only shareholders of record at the close of business on May 28, 1969 are entitled to notice of, and to vote at, the Meeting.

Shareholders are requested to specify their choices, date and sign the enclosed proxy and return in the reply envelope to which no postage need be affixed if mailed in the United States.

By order of the Board of Directors,

S. L. SABEL,
Secretary.

June 17, 1969

PROXY STATEMENT

This Proxy Statement is furnished to shareholders of AMERICAN INVESTORS FUND, INC. in connection with the solicitation of proxies to be used at the annual meeting of shareholders of the Fund. This meeting will be held on Tuesday, July 15, 1969, at the time and place and for the purposes set forth in the accompanying Notice of Annual Meeting of Shareholders. The solicitation is made by the management of the Fund and the cost of solicitation will be borne by the Fund.

If the enclosed form of proxy is executed and returned, it may nevertheless be revoked at any time before it is exercised. The shares represented by the proxy, if not limited to the contrary, will be voted for the election of directors and in favor of proposals 2 and 3. If a choice is indicated, the shares will be voted in accordance with the specifications so made.

The number of shares of Capital Stock of the Fund issued and outstanding, as of May 21, 1969, was 34,240,970. Each share is entitled to one vote. Only shareholders of record at the close of business on May 28, 1969 will be entitled to vote at the meeting.

Election of Directors

The proxy will be voted for the election of the following directors to hold office until the next annual meeting and until their respective successors have been elected and qualified:

Name, Principal Occupation or Employment	Year First Became Director	Shares Owned Beneficially 5/21/69
GEORGE A. CHESTNUTT, JR., President of the Fund; President of Chestnutt Corporation (Investment Adviser to the Fund)	1957	47,247*
JOHN CURRIER, President, Formfit Rogers Co., women's apparel manufacturer	1962	824
FRANK G. FOWLER, JR., Secretary and Treasurer of the Fowler Engineering Corp., municipal engineers and title surveyors	1962	251
WARREN K. GREENE, Vice President of the Fund; Vice President of Chestnutt Corporation; Vice President of Chestnutt Management Corporation, investment counselling subsidiary of Chestnutt Corporation	1966	470
RICHARD W. RADCLIFFE, Managing Partner, Fairfield Partners, an investment partnership, Greenwich, Connecticut	1958	618
STANLEY LAW SABEL, Senior Vice President and Secretary of the Fund; Senior Vice President and Secretary of Chestnutt Corporation	1957	7,811*
WILLIAM A. SEMMES, President, Semmes Motors, Inc., automobile dealer	—	—
FRANCIS L. VEEDER, Retired, managing own investments	1962	373

NOTE:

* Including 7,557 shares owned by Mr. Chestnutt's wife, Sara M. Chestnutt and 3,489 shares owned by Mr. Sabel's wife, Elizabeth C. Sabel, including two trusts of which she is trustee and has reversionary interests. Chestnutt Corporation in which Mr. Chestnutt and Mr. Sabel have interests as set forth under "Securities of the Investment Adviser", is the beneficial owner of 100,311 shares.

All of the nominees, except William A. Semmes, are now Directors of the Fund, elected by a vote of security holders at the last meeting, held on July 16, 1968, for which proxies were solicited. Mr. Semmes, a new nominee, has been President and Director of Semmes Motors, Inc., Scarsdale, N. Y. for more than five years. In the event that any of the above nominees should be unable to serve by reason of death or other unexpected occurrence, those who shall act as proxies will vote the proxy according to their best judgment.

During 1968 the Fund paid remuneration, including directors' fees, to its directors and officers aggregating $12,750; also Sutton, Sabel and Schupp, of which S. L. Sabel, an officer and director of the Fund, is a partner, received $6,500 during such period for legal services. $1,464,098 was paid by the Fund to its Investment Adviser, Chestnutt Corporation. George A. Chestnutt, Jr., is President and principal executive officer, Stanley Law Sabel is Senior Vice President and Secretary, and Warren K. Greene is Vice President of Chestnutt Corporation.

Securities of the Investment Adviser

The Investment Adviser, Chestnutt Corporation, has outstanding $171,400 of 6% Serial Income Bonds and 186,660 shares of Common Stock following a 5 for 1 stock split and reclassification on April 23, 1969. George A Chestnutt, Jr. owns 88,585 shares (47.5%) of Common Stock. Stanley Law Sabel owns $29,000 principal amount (16.9%) of Bonds, and 30,535 shares (16.4%) of Common Stock. George A. Chestnutt, Jr. and Stanley Law Sabel as trustees of a trust created on April 4, 1965, for members of Mr. Chestnutt's family and of which he is remainderman, hold $34,000 principal amount (19.8%) of Bonds. John Currier owns $3,600 principal amount (2.1%) of Bonds, and 2,200 shares (1.2%) of Common Stock. Warren K. Greene owns 675 shares (0.4%) of Common Stock. John F. Newton owns 165 shares (0.09%) of Common Stock. Vilas & Hickey received $44,537 in brokerage commissions from the Fund in 1968, and the wife of a registered representative of such firm owns $11,000 principal amount (6.4%) of Bonds and 11,970 shares (6.4%) of Common Stock. As owners of securities of the Investment Adviser, Chestnutt Corporation, George A. Chestnutt, Jr., Stanley Law Sabel, John Currier, Warren K. Greene and John F. Newton have an interest in the Investment Adviser and in the proposed new Investment Advisory Agreement referred to under "Approval of the Terms of New Advisory Agreement".

Information Pertaining to Investment Adviser and Investment Advisory Agreement

The Fund entered into its present advisory agreement with Chestnutt Corporation, 88 Field Point Road, Greenwich, Connecticut, following approval of the agreement by the shareholders at the Annual Meeting held on July 16, 1968. The principal executive officer of Chestnutt Corporation is George A. Chestnutt, Jr.; George A. Chestnutt, Jr., Stanley Law Sabel, Warren K. Greene and Clendon H. Lee are the Directors of Chestnutt Corporation; the principal occupations of Mr. Chestnutt, Mr. Sabel and Mr. Greene are as stated under "Election of Directors", and the address of Messrs. Chestnutt, Sabel and Greene is 88 Field Point Road, Greenwich, Connecticut; and the principal occupation of Clendon H. Lee is general practice of law. The advisory agreement is in

effect for two years from September 1, 1968, unless cancelled by either party on sixty days' notice and continues in effect thereafter so long as it is approved at least annually either (a) by a majority of the directors, including a majority of such directors who are neither affiliated persons of the investment adviser or of the Fund, other than as directors of the Fund, or (b) by a vote of a majority of the outstanding shares of the Fund.

The Investment Advisory Agreement provides that it cannot be amended, assigned or pledged and shall automatically and immediately terminate in the event it is amended, assigned or pledged by the Investment Adviser or by the Fund. The Investment Adviser is required to render research, statistical and advisory services to the Fund and make specific recommendations based on investment requirements; and to provide office space and related services, and pay all executive salaries and executive expenses.

The Investment Advisory Agreement provides for fees, calculated on the basis of net assets, determined quarterly which on an annual basis amounts to 0.8% on the first $50,000,000 of net assets of the Fund, 0.6% on the next $50,000,000, 0.4% on the next $200,000,000, 0.35% on the next $200,000,000, and 0.3% on all net assets in excess of $500,000,000. The annual fee is not more than an amount which will result in total charges per annum to the Fund, inclusive of the fee of the Investment Adviser (but exclusive of interest and taxes), of 1% of the value of the Fund's average monthly net assets for any year. The Adviser is required to render research, statistical, and advisory services to the Fund; to make specific recommendations based on the Fund's investment requirements; to provide office space and all necessary light, heat, telephone service, office equipment and stationery; and stenographic, clerical, mailing and messenger services in connection with such office; and to pay the salaries of all of the Fund's executives, and to pay all promotional, travel, and entertainment expenses relating to Fund sales.

Approval of the Terms of New Advisory Agreement

The Fund's Investment Adviser, Chestnutt Corporation, now owns and occupies its new office building at 83 Field Point Road, Greenwich, Connecticut, where it provides office space and related services to the Fund pursuant to the Investment Advisory Agreement between the Fund and Chestnutt Corporation.

The new Investment Advisory Agreement provides for fees at the same rates, has the same duration, and is subject to the same extensions as the present contract noted above, except that the initial two-year term (subject to cancellation by either party on 60 days' notice) will begin when the new contract is entered into on September 1, 1969. The new Agreement will provide that it cannot be amended, assigned or pledged. Approval of the new Investment Advisory Agreement could, to the extent deemed appropriate by defense counsel, be used as a defense in the Litigation described in this Proxy Statement.

The new Agreement to be adopted must be authorized by a vote of a majority of the outstanding shares of the Fund; by definition contained in the Investment Company Act of 1940 this means a vote of (a) holders of 67% or more of the shares of the Fund if holders of more than 50% of the outstanding shares of the Fund entitled to vote at the meeting are present in person or by proxy, or (b) holders of more than 50% of the outstanding shares of the Fund entitled to vote at the meeting, whichever is less.

Ratification of Selection of Independent Accountants

The Board of Directors has selected Price Waterhouse & Co., independent accountants, as auditors of the Fund for the year 1969, subject to ratification or rejection at this annual meeting.

Price Waterhouse & Co. has no other relationship with the Fund except as independent accountants. The employment of Price Waterhouse & Co. is conditioned upon the right of the Fund, by vote of holders of a majority of the outstanding stock at any meeting called for the purpose, to terminate such employment forthwith without any penalty.

Other Business

The management does not know of any other business which will be presented for action at the meeting. If business other than the above mentioned is brought before the meeting, those who shall act as proxies at the meeting will vote the proxy according to their best judgment.

Brokerage Commissions

The Fund's investment policies have resulted in a higher than average rate of portfolio turnover, 39.5% in 1966, 54.0% in 1967, and 81.9% in 1968, exclusive of all U. S. Government securities and all other securities whose maturities at the time of acquisition were one year or less. The Fund places orders for transactions in portfolio securities with brokers or dealers providing the most favorable prices and executions available. Speed and accuracy in obtaining market quotations, promptness in execution of orders at minimum commission rates, and prompt reporting of executions are absolutely essential. Among such brokers and dealers, those who have provided helpful information to the Fund, or have assisted in the sale of Fund shares, are given preference (without agreement so to do) in allocating brokerage business, but not at any sacrifice in price or execution. Whether or not such preference were given, the Fund would have to pay the same amount of commissions.

Helpful information obtained from brokerage sources involves quick, accurate quotations and data as to the size of the market; data on money statistics, earnings projections, dividend prospects; probable sellouts, mergers, consolidations, and liquidations; general tape action, with volume of shares, blocks recently traded or to be traded, who the buyers and sellers are believed to be, and other information as to the state of the market at a particular moment.

Brokerage commissions of $551,668 were charged to the Fund on purchases and sales of the Fund's portfolio securities in 1966, $1,995,087 in 1967, and $3,122,160 in 1968. Of such amounts the Fund allocated approximately $261,913 in 1966, $935,966 in 1967, and $2,022,457 in 1968, to brokers who provided helpful information, and approximately $289,755 in 1966, $1,059,121 in 1967, and $1,099,703 in 1968, in connection with the sale of Fund shares. Included in the above amounts allocated for helpful information and sale of Fund shares are brokerage commissions of $33,435 in 1966, $23,936 in 1967, and $44,537 in 1968, to Vilas & Hickey (the wife of a registered representative of which firm owned 6.3% of the voting and other securities of the adviser). Prior to December 5, 1968, when the practice was discontinued in the industry, the Fund in some instances

directed the broker who executed orders to give up to another broker a portion of his commission in accordance with stock exchange rules and regulations. The total amount of such give-ups during the last two fiscal years was $326,120 in 1967 and $633,095 in 1968. Since December 5, 1968, the Fund has discontinued directing give-ups but has continued giving preference in the allocation of brokerage business to such brokers and dealers who have provided helpful information or who have assisted in the sale of Fund shares. Following are tabulations showing for 1967 and 1968 the ten brokers who received the greatest amount of brokerage commissions by virtue of direct or indirect participation in the purchase or sale of portfolio securities for the Fund.

1967

Broker	Gross Commissions	Give-ups received	Give-ups paid
Hayden Stone & Co.	$232,128	$ 3,560	$ 22,885
Jesup & Lamont	193,652	—	50,742
Clark, Dodge & Co., Inc.	122,829	115	15,394
C. E. Unterberg Towbin	88,586	—	—
Tucker, Anthony & R. L. Day	83,645	350	—
E. F. Hutton Company, Inc.	79,098	635	1,457
Bateman Eichler, Hill Richards	19,018	57,915	—
Bear Stearns	111,697	224	36,245
McDonnell & Co.	64,772	1,125	—
G. A. Saxton	85,658	—	23,560

1968

Broker	Gross Commissions	Give-ups received	Give-ups paid
Jesup & Lamont	$311,067	—	$110,210
Pershing & Co.	188,295	—	123,060
Merrill Lynch, Pierce, Fenner & Smith, Inc.	178,506	$ 1,495	—
Hayden Stone, Inc.	174,763	14,985	28,598
G. A. Saxton & Co., Inc.	170,356	—	79,892
Bear Stearns	140,949	1,000	35,405
Thomson & McKinnon, Inc.	126,833	—	31,905
Clark, Dodge & Co., Inc.	103,968	—	7,985
Sidney A. Siegel & Co., Inc.	99,949	—	—
Model Roland	98,624	—	17,445

Without knowing what the results would have been absent the helpful information, the Fund knows of no way to determine the approximate value of helpful information obtained. Helpful economic information relating to particular investment situations, received by the Fund, is generally unsolicited and offered by a broker to stimulate business. It is the practice of the Fund upon receiving such helpful information from brokerage sources to refer such information to its investment adviser, for verification and opinion as to validity, accuracy, and for further research and recommendation as to the desirability of acting upon such information. This involves

work by the adviser with related costs, and to the extent such information can be utilized, such information can aid the Adviser in achieving better investment performance for the Fund. The information itself, for which the Fund allocated approximately $546 in 1966, $7,664 in 1967, and $7,615 in 1968, aided the adviser in performing its obligations under its advisory contract with the Fund as well as benefiting the Fund.

Litigation

Directors of the Fund and the adviser, Chestnutt Corporation, are defendants and the Fund is a nominal defendant in two derivative actions brought in January, 1967, and July, 1968, respectively, in the United States District Court for the Southern District of New York by joint shareholders, Rosalind Fogel and Gerald Fogel, holders of 276 and a fraction shares (which comprise 51.187 shares held on January 6, 1967, when the first action was started, 1.068 shares acquired as a shares distribution—accepted in lieu of cash—on January 20, 1967; 0.136 shares accepted as such a share distribution on May 26, 1967; 5.135 shares purchased for $200 on January 8, 1968; 4.386 shares accepted as such a share distribution on January 19, 1968; 185.736 shares received as a result of the four-for-one stock split on July 16, 1968; 8.580 shares accepted as such share distribution on January 23, 1969; and 20.080 shares purchased for $200 on January 10, 1969). The first action alleges, among other things, that the investment advisory fees are excessive and that by reason of brokerage commissions (which were the standard minimum stock exchange commissions) of Jesup & Lamont, The Fund of Funds Ltd. in effect received a rebate and thus purchased shares of the Fund at prices different from the public offering described in the Prospectus. The action seeks an injunction and to have the directors of the fund, the management corporation, The Fund of Funds and its affiliate I.O.S. Ltd. (S.A.), and Jesup & Lamont restore to the Fund the brokerage commissions paid to Jesup & Lamont and to have such defendants account for, and pay to, the Fund the advisory fees received by them since 1963. The second action alleges, among other things, that the management corporation, by the use of reciprocal brokerage, give-ups, and mark-ups and mark-downs in over-the-counter transactions, received compensation in excess of the amounts provided for in the investment advisory contract, and that such alleged excess compensation should be recaptured for the benefit of the Fund and seeks an injunction in addition to damages for failure to secure such recapture. No recovery is sought from the Fund, in either action. Nevertheless, this litigation will result in additional expenses to the Fund by way of legal services and by way of probable reimbursement of expenses incurred by Officers and Directors in defending the suit. It is not possible at this time to anticipate the amount of such expenses. In the opinion of both the General Counsel of the Investment Adviser and Messrs. O'Connor & Farber, Special Counsel retained by the Investment Adviser, the suits have no merit.

By order of the Board of Directors,

GEORGE A. CHESTNUTT, JR.
President

Dated: June 17, 1969

The following statement is not a balance sheet of American Investors Fund, Inc., but is a consolidated balance sheet of the investment adviser, Chestnutt Corporation, as required to be included in the Proxy Statement by Rule 270.20a-2(a)(9) of the regulations issued by the Securities and Exchange Commission under the Investment Company Act of 1940.

CHESTNUTT CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

December 31, 1968

ASSETS

CURRENT ASSETS:		
Cash		$ 39,136
Accounts receivable:		
American Investors Fund, Inc. (Note 2)	412,048	
Other	77,193	
	489,241	
Investment in 100,311 shares of American Investors Fund, Inc., at cost—redemption value $1,071,314 (Note 3)		797,819
Prepaid expenses		49,879
Total current assets		1,376,075
PROPERTY AND EQUIPMENT, at cost:		
Land (Note 4)	333,686	
Office building (Note 4)	547,539	
Leasehold improvements (Note 7)	11,780	
Furniture, fixtures and equipment	268,862	
	1,161,867	
Less—Accumulated depreciation and amortization (Note 8)	239,779	
	922,088	
GOODWILL, COPYRIGHTS, METHODS, CALCULATIONS AND PROCEDURES	1	
	$2,293,164	

LIABILITIES AND SHAREHOLDERS' EQUITY

CURRENT LIABILITIES:	
Current portion of long-term debt (Notes 4 and 5)	$ 22,762
Demand notes payable to bank, secured (Note 3)	580,000
Accounts payable	66,090
Accrued liabilities	116,472
Estimated taxes on income	271,468
Deferred management advisory fees and service subscriptions	205,873
Total current liabilities	1,262,665
LONG-TERM DEBT:	
Mortgage debt payable, less current portion (Note 4)	401,392
6% serial income bonds due 1969-1976, less current portion (Note 5)	161,200
	562,592
SHAREHOLDERS' EQUITY:	
Common stock—no par value:	
Class A, nonvoting—authorized and issued 25,200 shares	252
Class B, voting—authorized and issued 12,600 shares	126
	378
Retained earnings	537,029
	537,407
Less—Cost of common stock, 430 shares Class A and 215 shares Class B in treasury	64,500
	472,907
CONTINGENT LIABILITY (Note 6)	
	$2,293,164

CHESTNUTT CORPORATION AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

Note 1—PRINCIPLES OF CONSOLIDATION:

The consolidated financial statements include the accounts of Chestnutt Corporation and its wholly owned subsidiaries, Chestnutt Management Corporation, Field Point Advertising Agency, Inc. and Field Point Travel Agency, Inc. All intercompany accounts and transactions have been eliminated in consolidation.

Note 2—INVESTMENT ADVISORY AGREEMENT WITH AMERICAN INVESTORS FUND, INC.:

The advisory fee ($1,464,093, 1968; $1,087,993, 1967) from American Investors Fund, Inc., with which the principal officers of the Corporation and two of the three directors are affiliated, was received pursuant to an investment advisory agreement. The investment advisory agreement includes a provision among other things, for the payment by the Fund of a fee determined on the basis of the net asset value of the Fund at the end of each quarter as follows:

Annual Rate	Total net asset value
0.8%	First $50 million
0.6	Next $50 million
0.4	Next $200 million
0.35	Next $200 million
0.3	Excess of $500 million

The Corporation has agreed to refund each year any amount by which total expenses of the Fund, exclusive of taxes and interest, exceeds 1% of average monthly net assets of the Fund for such year. No such refund was required for the year 1968.

Note 3—DEMAND NOTES PAYABLE TO BANKS, SECURED:

At December 31, 1968, the Corporation was indebted to banking institutions on interest bearing loans in the amount of $580,000 at 6¾% and 7% interest rates; $480,000 of this indebtedness is secured by 96,949 shares of American Investors Fund, Inc. The balance of $100,000 was paid in January, 1969. The net asset value per share of American Investors Fund, Inc. was $9.25 at March 14, 1969.

Note 4—MORTGAGE DEBT:

The mortgage debt at December 31, 1968, exclusive of principal amounts payable in 1969 included in current liabilities, is summarized as follows:

	Annual interest rate	Amount
Annual principal installment of $5,000 required. Secured by real estate with a book value of $50,000	5¾%	$ 30,000
Interest payable quarterly to August 23, 1971, when principal becomes due. Secured by land with a book value of $200,000 at December 31, 1968	6¼%	150,000
Quarterly payments of $3,000 (including interest) required to September 1, 1980, when remaining principal and interest of $111,212 becomes payable. Secured by real estate having a book value of $626,416 at December 31, 1968	5½%	221,392
		$401,392

Note 5—6% SERIAL INCOME BONDS:

The Corporation is indebted to bondholders in the amount of $171,400 (primarily to shareholders) on 6% serial income bonds due in principal amounts of $10,200 on each July 31 until July 31, 1975, when the balance of $100,000 is due and payable.

The payment of interest in any year may be limited by the Corporation to the net income of the preceding year. However, in the event of nonpayment, interest is cumulative to the extent of 18% of the principal amount of the bonds outstanding. Interest is payable yearly on February 1, and has been paid to February 1, 1970.

Note 6—CONTINGENT LIABILITY:

See under "Litigation" in body of Proxy Statement.

Note 7—LEASED FACILITIES:

In April, 1967, the Corporation leased office space (being used by the subscription and mailing department) for two years at an annual rental of $6,000 with an option since exercised to renew for an additional two-year period.

Note 8—DEPRECIATION AND AMORTIZATION:

Depreciation and amortization amounted to $78,394 in 1968 and $85,484 in 1967. The Corporation uses the sum of the year digits method in computing its depreciation for the new assets purchased subsequent to 1967, and the straight-line method for all other assets.

OPINION OF INDEPENDENT ACCOUNTANTS

To the Board of Directors
and Shareholders of Chestnutt Corporation

In our opinion, the accompanying consolidated balance sheet presents fairly the financial position of Chestnutt Corporation and its subsidiaries at December 31, 1968, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. This opinion is based on an examination which was made by us in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Price Waterhouse & Co.
PRICE WATERHOUSE & CO.

Stamford, Connecticut
March 14, 1969

EXHIBIT I

INVESTMENT ADVISORY AGREEMENT
between
AMERICAN INVESTORS FUND, INC.
and
CHESTNUTT CORPORATION

AGREEMENT made as of September 1, 1969, by and between AMERICAN INVESTORS FUND, INC., a corporation organized and existing under the laws of the State of New York (herein called the "Corporation"), and CHESTNUTT CORPORATION, a corporation organized and existing under the laws of the State of Connecticut (herein called the "Investment Adviser").

WHEREAS, the Corporation is engaged in business as an open-end management investment company, and is registered under the Investment Company Act of 1940, and—

WHEREAS, the Investment Adviser is engaged in the business, among other things, of rendering research, statistical, and advisory services to investors, and is registered under the Investment Advisers Act of 1940.

NOW, THEREFORE, in consideration of the premises and of the mutual promises hereinafter set forth, the parties hereto agree as follows:

1. The Corporation hereby retains the Investment Adviser to render research, statistical and advisory services to the Corporation, and to assist and guide the officers and directors of the Corporation in the investment administration of its resources, so long as this agreement shall remain in effect.

2. The Investment Adviser hereby accepts such retainer and agrees to render such services to the best of its ability.

3. The Corporation will, from time to time, deliver to the Investment Adviser detailed statements of the investments and resources of the Corporation and information as to its investment problems.

4. The Investment Advisor shall, from time to time, to the extent reasonably required in the conduct of the business of the Corporation and upon its request, make available to the Corporation research, statistical, and advisory reports and charts upon the industries, businesses, corporations, and securities as to which such requests shall be made, whether or not the Corporation shall at the time have any investment in such industries, businesses, corporations, or securities.

5. The Investment Adviser shall, from time to time, taking into consideration the investment requirements of the Corporation, recommend to the Corporation that it adopt specified investment

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policies, or that it purchase, sell, retain, or exchange designated securities; and the Corporation, acting on such recommendations, may, but shall not be required to, adopt such policies or purchase, sell, retain, or exchange such securities.

6. The officers and advisory personnel of the Investment Adviser shall be available at all times upon reasonable notice for consultation with the directors and officers of the Corporation in connection with any of the Corporation's investment problems.

7. The Investment Adviser shall furnish to the Corporation such office space as may be necessary for the suitable conduct of the Corporation's business and all necessary light, heat, telephone service, office equipment and stationery and stenographic, clerical, mailing and messenger service in connection with such office; and pay the salaries of all of the Fund's executives, and pay all promotional, travel, and entertaining expenses relating to Fund sales.

8. The Investment Adviser shall not be liable for any loss sustained by reason of the adoption of any investment policy or the purchase, sale, or retention of any security on the recommendation of the Investment Adviser, whether or not such recommendation shall have been based upon its own investigation and research or upon investigation and research made by any other individual, firm, or corporation, if such recommendation shall have been made and such other individual, firm, or corporation shall have been selected with due care and in good faith; but nothing herein contained shall be construed to protect the Investment Adviser against any liability to the Corporation or its security holders by reason of wilful misfeasance, bad faith, or gross negligence in the performance of its duties or by reason of its reckless disregard of its obligations and duties under this Agreement.

9. The Corporation agrees to pay to the Investment Adviser and the Investment Adviser agrees to accept as full compensation for all services rendered by the Investment Adviser hereunder for each of the Corporation's fiscal quarters on the last day of each quarter, a fee in an amount determined by applying the following quarterly rates to the value of the Corporation's net assets at the end of each calendar quarter:

Quarterly Rate	Equivalent Annual Rate	Asset Value of the Corporation
0.2 of 1%	0.8 of 1%	on the first $ 50 million
0.15 of 1%	0.6 of 1%	on the next $ 50 million
0.1 of 1%	0.4 of 1%	on the next $200 million
0.0875 of 1%	0.35 of 1%	on the next $200 million
0.075 of 1%	0.3 of 1%	on asset value in excess of $500 million

provided, however, that the annual fee of the Investment Adviser shall not be more than an amount which, when added to the other charges of the Corporation (exclusive of interest and taxes) shall result in total charges per annum of the Corporation inclusive of the fee of the Investment Adviser (but exclusive of interest and taxes) of 1% of the value of the Corporation's average monthly net assets for any year. For the first quarter in which this Agreement shall be in effect,

the foregoing computations shall be made as if this Agreement was in effect for the entire quarter. For the quarter and the year in which this Agreement terminates, there shall be an appropriate proration on the basis of the number of days that this Agreement is in effect during the quarter and the year respectively. If, pursuant to the Certificate of Incorporation of the Corporation, the asset value is not required to be determined on any particular business day, then for the purpose of the foregoing computations, the asset value last determined shall be deemed to be the asset value as of the close of business on that day.

10. The Investment Adviser agrees that it shall not take any long or short position in the stock of the Corporation but this prohibition shall not:

(a) prevent the Investment Adviser, acting as or for a distributor of the stock of the Corporation, from purchasing shares of such stock, if orders to purchase such shares are placed by the distributor upon receipt of purchase orders for such shares and are not in excess of the purchase orders received by the distributor;

(b) prevent the Investment Adviser, acting as or for a distributor of the stock of the Corporation, from maintaining a market for such stock in the capacity of agent for the Corporation; or

(c) prevent the purchase by or for the Investment Adviser of shares of the stock of the Corporation at the price at which such shares are available to the public at the moment of purchase; provided that such purchase be made for investment purposes only.

11. This agreement shall remain in effect for a period of two years from the date hereof unless sooner terminated as hereinafter provided. This agreement shall continue in effect from year to year thereafter, subject to the provisions for termination and all of the other terms and conditions hereof, but only so long as such continuation shall be specifically approved at least annually by (i) a majority of the Board of Directors, including a majority of such Directors who are neither affiliated persons of the Investment Adviser or of the Corporation, other than as directors of the Corporation, or, (ii) by the affirmative vote of holders of a majority of the shares of the Fund.

12. Nothing in this agreement shall prevent the Investment Adviser or any director, officer or employee thereof from acting as Investment Adviser for any other person, firm, or corporation and shall not in any way limit or restrict the Investment Adviser or any of its directors, officers or employees from buying, selling or trading in any securities for its or their own accounts or for the accounts of others for whom it or they may be acting.

13. This agreement cannot be amended, transferred, assigned, sold or in any manner hypothecated or pledged (herein called "amended, assigned or pledged"); in the event of cancellation or expiration of this agreement or other management contract, no new management contract shall become effective without the affirmative vote of holders of a majority of the shares of the Fund. This agreement shall automatically and immediately terminate in the event it is amended, assigned or pledged by the Investment Adviser or by the Corporation.

14. This agreement may be terminated (a) by the Corporation, upon sixty (60) days' notice in writing to the Investment Adviser without the payment of any penalty, provided such termination be authorized by resolution of the Board of Directors of the Corporation or by vote of holders of a majority of the shares of the Fund; and (b) by the Investment Adviser, upon sixty (60) days' notice in writing to the Corporation, likewise without penalty.

15. For the purpose of this agreement, the "affirmative vote of holders of a majority of the shares of the Fund" means the affirmative vote, at a duly called and held meeting of shareholders of the Fund, (a) of the holders of 67% or more of the shares of the Fund present (in person or by proxy) and entitled to vote at such meeting, if the holders of more than 50% of the outstanding shares of the Fund entitled to vote at such meeting are present in person or by proxy, or (b) of the holders of more than 50% of the outstanding shares of the Fund entitled to vote at such meeting, whichever is less.

For the purposes of this agreement, "affiliated person" shall have the meaning defined in the Investment Company Act of 1940, as in force at the time, or in any act amendatory thereof or in substitution therefor, as in force at the time.

For the purposes of this agreement, "assignment" shall have the meaning defined in the Investment Company Act of 1940, as in force at the time, or in any act amendatory thereof or in substitution therefor, as in force at the time.

IN WITNESS WHEREOF, the parties hereto have caused this agreement to be duly executed the day and year first above written.

AMERICAN INVESTORS FUND, INC.

Attest:

By .....
President

.....
Secretary

CHESTNUTT CORPORATION

Attest:

By .....
President

.....
Secretary

U. S. DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

ROSALIND FOGEL AND GERALD FOGEL, Plaintiffs, against GEORGE A. CHESTNULT, JR., ET AL, Defendants	:	68 Civ. 2885

May 16, 1973
Washington, D. C.

DEPOSITION OF:

LLOYD J. DERRICKSON

called for examination by counsel for plaintiffs pursuant to notice at 1156 15th Street, Northwest, Washington, D. C. beginning at 10:08 o'clock a.m. before Stephen B. Miller, notary public, when were present on behalf of the respective parties;

For the Plaintiffs:

RICHARD MEYER, ESQ.
DANIEL DRASNER, ESQ.
Pomerantz, Levy, Haudek and Block
295 Madison Avenue
New York, New York 10017

For Defendants Chestnult, et al.:

CLENDON H. LEE, ESQ.
Rogers, Hoge and Hills
90 Park Avenue
New York, New York 10016

For Defendant American Investors Fund, Inc.

ROBERTA KARMEL, ESQ.
Royall, Koegel and Wells
200 Park Avenue
New York, New York 10017

- - -

I N D E X

WITNESS	EXAMINATION	FURTHER
Lloyd J. Derrickson	3	
	8	
	21	23

P R O C E E D I N G S

WHEREUPON --

LLOYD J. DERRICKSON

was called for examination by counsel for Plaintiff, having been sworn by Stephen B. Miller, was examined and testified as follows:

EXAMINATION BY COUNSEL ON BEHALF OF THE PLAINTIFF

BY MR. MEYER:

Q Mr. Derrickson, state your full name and address for the record.

A Lloyd J. Derrickson, 1735 K Street, Northwest, Washington, D. C. 20006.

Q Mr. Derrickson, what is your occupation?

A General Counsel for the NASD. My title is Senior Vice President and General Counsel.

Q How long have you been associated with the NASD?

A I first became associated with them as outside counsel in 1958, and then I became full time in 1962 approximately.

Q The NASD stands for what?

A National Association of Securities Dealers Incorporated.

Q That is a self-regulatory agency under the Securities and Exchange Act of 1934, is that correct?

A That is right, under the Maloney Act Amendment. It is a registered securities association.

Q Mr. Derrickson, are you familiar with the constitution and rules of the NASD?

A Yes, I am.

Q Have you been familiar with them since 1962?

A Even before that.

Q Are you familiar with the requirements of the NASD insofar as they pertain to applications for membership?

A Yes, I am.

Q Beginning in 1962, can you tell us what those requirements were?

A Well it is two or three pages of printed material. It is in the manual. Would you like for me to try and capsulate it in my own words?

Q No, I won't ask you to do that. Let me pose you certain situations and ask you your opinion on them.

MR. LEE: Mr. Meyer, you have asked for his opinion. Are you going to interrogate this witness as to any personal knowledge as to any of the parties in this action?

MR. MEYER: I do not intend to, but I may. If I do, feel free to speak up at that time.

BY MR. MEYER:

Q Mr. Derrickson, it was permissible, was it not, for an investment advisor for a mutual fund to obtain NASD membership, is that correct?

MR. LEE: Objection as to the form of that question. I suggest that the best evidence of the rules of NASD is the manual to which the witness has referred.

BY MR. MEYER:

Q You may answer.

A If the investment advisor had all the qualifications stated in the by-laws and in the statute, yes.

Q In order to obtain membership, it was necessary, was it not, to pass a test?

A For whom?

Q For the officers of the applicant.

A I don't think that was true in 1962. Certainly as to a registered representative, obviously it was necessary to have one. There was a qualifications examination.

Q Maybe you better capsulate the requirements as best you can.

MR. LEE: Just for purposes of the record, the record should show my objection to this line of questioning. The witness has already stated the requirements as set forth in the rules.

THE WITNESS: They have changed over the years. I can't give you the exact date. Let me put it this way, if you would like me to, it would have been necessary that some person pass an examination, some principal or owner, if he were the sole proprietor, et cetera. Fairly recently there has been a requirement for a principal's examination, those designated as principals, and this is spelled out in the manual.

Generally speaking, there is a free entry policy. Anyone can become a broker-dealer under the 1934 act who meets the statutory requirements. Anyone can join the NASD who meets the statutory requirements of the state or the federal law and who also meets the requirements that we impose, which include an examination of the representative and also registered principals at this time.

Q Was it at any time necessary since 1962 that prior to becoming a member of the NASD an applicant actually have executed a brokerage transaction?

A No.

Q Was it at any time since 1962 necessary for an applicant who became a member of the NASD actually to execute a brokerage transaction in order to remain a member of the NASD?

A No. I should add of course that I do not think there are many firms who go to the trouble of becoming broker-dealers

and paying the fees and costs that do not intend to do that, and there is a requirement that they state the business they intend to engage in on the application. It would probably be illegal to engage in a brokerage transaction on a regular basis for a person who is not registered, either with the Commission or with the NASD.

Q Is there any requirement that a member of the NASD hold himself out and do business with the general public?

A No.

Q If an investment advisor of a registered investment company applied for membership of the NASD and stated that its intention was merely to receive give-ups, when give-ups were permissible, and to credit those give-ups against the advisory fees which it charged to the mutual fund, would that in any way restrict it from becoming a member of the NASD?

MR. LEE: Objection as to the form of the question, purely hypothetical.

THE WITNESS: As I understand your question, a broker-dealer who stated that was his intention would have, in all probability, under most circumstances, been admitted on the assumption that he had the qualifications, had become a broker-dealer with the Commission or state.

MR. LEE: I move to strike.

BY MR. MEYER:

Q Would your answer to the last question be any different if the applicant were an affiliate of the investment company itself, rather than of the investment advisor?

MR. LEE: Same objection, purely hypothetical.

THE WITNESS: I don't think it made any difference.

MR. LEE: Move to strike.

MR. MEYER: I have no further questions.

EXAMINATION BY COUNSEL ON BEHALF OF DEFENDANTS CHESTNULT, ET AL.

BY MR. LEE:

Q Mr. Derrickson, I have a green covered booklet captioned National Association of Securities Dealers, Inc., reprint of the manual, bearing the date of March 1968. I have only one copy and I am not going to ask that this be marked, if I can get the cooperation of the counsel for the Plaintiffs, but may I show you this manual?

A Certainly.

Q Can you by looking at that manual tell me whether between the date of March 1960 and the date in December 1968 when give-ups were abolished on the National Securities Exchanges, whether there were any changes in the rules with respect to definitions of membership in that manual?

A No, because this is dated March 1968 and I don't

have anything that shows me what happened from March to December.

Q And you are not able to tell us of your own recollection as to whether there were any changes?

A No.

Q I invite your attention, Mr. Derrickson, to Section 1 of Article 1, and for purposes of clarifying the record, I will take the liberty of reading it into the record.

Article 1 is entitled "Membership." There is a subheading which may be editorial, I do not know, but in this printing it says:

> "Qualifications for membership. Section 1. Any broker or dealer authorized to transact and whose regular course of business consists in actually transacting any branch of the investment banking or securities business in the United States, under the laws of any state and or the laws of the United States shall be eligible to membership in the corporation, except such brokers or dealers as are excluded pursuant to Section 2 of this article."

Is that the definition which was in effect at the time of the printing of that manual in March, 1968?

A I feel quite sure it is. I think it has not been

changed since its inception in 1939.

Q Skipping on down to Section 3, which appears on page 1059 of this printed manual under the caption "Definitions," Section 3 then reads:

"When used in these By-Laws, unless the context otherwise requires: 'broker' Subparagraph a, the term broker means any individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization or other legal entity engaged in the business of effecting transactions in securities for the account of others but does not include a bank."

Now I ask you, Mr. Derrickson, whether to the best of your recollection that is a true statement of the definition as it existed in March 1968 at the time this manual was apparently printed?

A I don't remember if it was, but I can answer it this way: you just read it, and I would say that that is the original definition dating back to 1939, as approved by the Commission, and I don't think it has been changed.

Q Hasn't been changed either between March 1968 and December 1968, nor since that time?

A Correct.

Q I invite your attention to the further definition in Subparagraph b of Section 3 which I will likewise read into the record, if I may.

"Dealers. (b) The term 'dealer' means any individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization or other legal entity engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business."

Mr. Derrickson, is that Subparagraph (b), which I have just read to you, and as reprinted in this March 1968 manual, to the best of your recollection an accurate statement of the definitional provision with respect to dealer as it applied in March, 1968?

A Yes, it is. If that is the correct manual, if there are no misprints, that is what it would have been in my opinion. I can't say precisely that I remember that that is what it was then, but I don't think -- I will answer it the same way as I did the prior question.

Q So to the best of your knowledge, that is an accurate statement of the definitional part of the rules?

A Yes.

Q And continues in effect in substantially this form today?

A If not identical, I would say identical.

Q I understood you to say in your direct examination that obviously a broker-dealer would have to have a registered representative, one or more registered representatives, was that correct?

MR. MEYER: I object. The record will show what the witness said.

THE WITNESS: In order to transact business a person or an individual would have had to qualify by passing an examination in order to do business.

BY MR. LEE:

Q As a registered representative?

A Yes.

Q And such a registered representative would be doing business for others I take it, the definition of broker, which I read to you?

A That is right.

MR. MEYER: May I have a clarification. Do you mean

"by others," you mean others than himself? Is that what you mean?

MR. LEE: I think the rule states --

MR. MEYER: I do not know if the witness understood the question properly. I so understood it as meaning, when you refer to "others," as others than himself.

MR. LEE: I think that is very likely a correct interpretation. The definition of "broker" includes the language "engaged in the business of effecting transactions in securities for the account of others."

MR. MEYER: Your question did not concern the broker. It concerned a registered representative.

BY MR. LEE:

Q Would a registered representative be the means whereby a securities transaction was effected for others?

A Yes. It is not the only way. A registered representative might be a principal. There might be only one person in the firm --

Q But that person would be a registered representative?

A That is right.

Q And would need to be a registered representative in order to transact business for others?

A That is right.

Q Mr. Derrickson, was it ever the policy of the NASD to include within its membership applicants who did not effect transactions and securities for the account of others?

A The statute requires that we accept members if they qualify under the by-laws and other requirements that the Board sets out in the manual. In this case it is terms of a schedule, setting forth examination requirements, et cetera,which you have read I am sure.

If I understand your question correctly, you say was it ever the policy to exclude persons who did not do business?

MR. LEE: I think I will ask the reporter to read the question.

(Question read by reporter.)

BY MR. LEE:

Q So that I ask it in terms of including in the membership persons or entities who did not transact business for others?

A The association never had a stated policy or took a position in terms of excluding such persons. The statute required that they be admitted, if they were going to engage in business.

Q That is not my question.

MR. MEYER: Let the witness finish his answer.

THE WITNESS: I am not sure what you mean by the question.

BY MR. LEE:

Q I am quoting your own rule, Mr. Derrickson, your definitional rule, that membership as a broker would require that a person be in the business of effecting transactions in securities for the account of others.

MR. MEYER: I object to your statement of the rule. That is not what the rule provides. The rule speaks for itself.

MR. LEE: I am trying to interrogate this witness as to whether it was the policy of the NASD to admit people who did not meet this requirement of the definitional rule of transacting business for others.

MR. MEYER: I object to your characterization of it as a requirement.

THE WITNESS: You want me to try and answer it now?

MR. LEE: I would like for you to answer.

MR. MEYER: You may answer.

THE WITNESS: Obviously from the definition, the intention is that the applicant intend to conduct a business as a broker or dealer. The association, if my recollection is accurate, at one time attempted to either exclude from membership or to deregister broker-dealers who were not doing

business.

BY MR. LEE:

Q For others?

A For anyone. In other words, dormant type operations. Now this is subject to review by anyone, because if I am correct, [illegible] the Commission I think stopped us from doing that. This goes back quite some years, as I recall, on the theory that the statute permitted them to become members and that they could engage in business at any given moment, despite the fact that they may not be doing so at any given time. So that generally speaking, under the philosophy of the Maloney Act, as we understood it, a person stating a desire and qualifying otherwise would be admitted to membership.

Now if I understand your question or what you are driving at, it goes to whether or not what is transacting business -- I don't have a phrase in front of me -- and would we have excluded a person who stated that his business was receiving give-ups?

Q That is not my question. My question relates solely to the actual fact or the bonafide intent of an applicant to transact business for others in securities, to effect securities transactions for others?

A Well, I can say we have never had a policy of delving

into that question or questioning what is -- what the applicant's bonafide intentions were.

Q But if you did require either that the applicant do business or set forth an attempt to do business for others?

A The form is clear on this; and if you were to get the form or if I were to get them for you, you could see what the question is. I do not recall offhand. But there is a question, if I am correct, asking the applicant what type of business he intends to engage in. So there would be a statement on the applicant's application form so indicating.

Q Mr. Derrickson, I invite your attention to the third subparagraph of Section 3, which is captioned "Investment Banking or Securities Business." And since I don't have an extra copy of this, I will proceed in the same manner as I did before.

MR. MEYER: Off the record.

(Discussion off the record.)

BY MR. LEE:

Q It reads: "Investment banking or securities business. (c) The term 'investment banking or securities business' means the business, carried on by broker or dealer, of underwriting or distributing issues of securities, or of purchasing securities and offering the same for sale as a dealer therein, or of purchasing and selling securities upon the order and for

the account of others; provided, however, that the term 'investment banking or securities business' shall not include transactions or regularly organized exchanges, but such term shall include all business relating to such transactions to the extent such business is not conducted by a member of such exchange, or by any person or organization having the privilege of any such exchange for itself or any of its partners or executive officers."

A. I have read it.

Q. To the best of your recollection, is this a correct statement of the rule as it existed in March 1968?

A. Yes, I think it is.

Q. And such rule would have continued to exist through December 1968 when give-ups were abolished?

A. Yes.

Q. Does it comport with your recollection as being substantially the existing provision of the rule?

A. Yes.

Q. I invite your attention to the language "carried on by a broker or dealer" and skipping a few words "and offering the same for sale as a dealer therein, or of purchasing and selling securities upon the order and for the account of others."

Does that mean to your mind that a broker or dealer

would have to do these things in order to comply with the definition of broker and dealer and to engage in membership to become a member of NASD?

A. When you say "above" --

MR. MEYER: Could I have the question read back.

(Question read by reporter.)

MR. MEYER: I object to that. You are reading only part of the definition. It later says that that the term investment banking or securities business shall include all business relating to such transactions, which refer to transactions on exchanges, and I think that is in addition to the language that you read.

BY MR. LEE:

Q Bearing in mind Mr. Meyer's further quotation from the definition, Mr. Derrickson, can you answer my question now that a broker or dealer would have to either do these functions or have a bonafide intention of doing these functions in order to meet the earlier requirements of Section 3?

MR. MEYER: I don't know what you mean by "these functions." I think if you include the language that I read, which at least to my thinking includes the receipt of give-ups, then I will accept the definition of "these functions."

MR. LEE: I will not accept that in any way, shape

or form.

MR. MEYER: Then your question is very unclear to me. I object to it.

MR. LEE: I have no further questions, Mr. Derrickson.

THE WITNESS: May I go off the record?

MR. LEE: Yes.

(Discussion off the record.)

BY MR. LEE:

Q Well see if you can answer that question.

A You said to my mind is there a requirement that a broker-dealer fulfill the definitional statement in our by-laws, and as I indicated earlier, the application form indicates that he is to state what he intends to do. I would not necessarily think that he must act as a broker, as stated in the definition. He could also act as a dealer, obviously; and, thirdly, the transactions in connection with "the other types of business related to" would have a bearing. I think it is a very broad statement of what the investment banking securities industry is. Exactly what it means in any given set of facts or circumstances would depend on what they were.

MR. LEE: I have no further questions.

MS. KARMEL: I have a question.

EXAMINATION BY COUNSEL ON BEHALF OF DEFENDANT AMERICAN INVESTORS FUND, INC.

BY MS. KARMEL:

Q Mr. Derrickson, are you aware whether during the period 1962 until give-ups were abolished by the New York Stock Exchange there were any NASD members whose sole function was the receipt of give-ups?

A I can't say for certain, but I think there probably were. That would be my best estimate.

Q Do you know of any specific broker-dealers?

A Right today -- I have some recollection that we did have such members, but I am not sure who it was and when it was. I have some recollection it could have been Kansas City Securities, for example. I can't say obviously, I don't know.

FURTHER EXAMINATION BY COUNSEL ON BEHALF OF DEFENDANTS CHESTNULT, ET AL

BY MR. LEE:

Q May I just ask this one question brought out in effect by Ms. Karmel's question. Kansas City Securities is of course a distributor of a load fund, is it not?

MR. KRASNER: I object to that statement.

MR. MEYER: You can't object. Let him ask it.

BY MR. LEE:

Q Can you answer the question?

A I don't know. I think the distributor for that group of funds is Waddell and Reed. I think Kansas City Securities -- and I could be entirely incorrect on the timing of this -- I think Kansas City Securities was a separate entity formed solely for another purpose.

Q It is a load fund. The funds in Kansas City group are load funds, are they not?

A Yes.

MR. LEE: No further questions.

MR. MEYER: No questions.

THE WITNESS: Can I go off the record?

(Discussion off the record.)

MR. MEYER: I will frame a question. Mr. Derrickson just stated a clarification off the record to me, which I will not ask that he put on the record.

MR. LEE: I object to the form of that. I don't want a statement made. It was a hypothetical statement. If you want to ask a hypothetical question of the witness --

MR. MEYER: I will withdraw that. I will ask him a hypothetical question.

FURTHER EXAMINATION BY COUNSEL ON BEHALF OF PLAINTIFFS

BY MR. MEYER:

Q Mr. Derrickson, if you had received an application from anyone saying that they wanted to become a member of the NASD for the sole purpose of receiving give-ups and crediting those give-ups against advisory fees charged by such applicant to a fund that it was advising, would the NASD have refused that application?

MR. LEE: Objection to the form of the question.

THE WITNESS: No, I don't think we would have refused it.

MR. LEE: Move to strike. Purely hypothetical.

MR. MEYER: That's all.

(Whereupon at 11:40 o'clock a.m. the taking of the deposition was concluded.)

NATIONAL ASSOCIATION

OF

SECURITIES DEALERS, INC.

Reprint of the Manual

January 20, 1972

Plaintiffs' Ex. 21

BY-LAWS

ARTICLE I

Membership

¶ 1101 Qualifications for Membership

Sec. 1. Any broker or dealer authorized to transact and whose regular course of business consists in actually transacting any branch of the investment banking or securities business in the United States, under the laws of any State and/or the laws of the United States, shall be eligible to membership in the Corporation, except such brokers or dealers as are excluded pursuant to Section 2 of this Article.

¶ 1102 Restrictions on Admission to or Continuance in Membership

Sec. 2. (a) No broker or dealer, except with the approval or at the direction of the Securities and Exchange Commission (hereinafter referred to in these By-Laws as the Commission), in cases in which the Commission finds it appropriate in the public interest so to approve or direct pursuant to Section 15A of the Securities Exchange Act of 1934, as amended (hereinafter referred to as the Act), shall be admitted to or continued in membership in the Corporation if such broker or dealer, whether prior or subsequent to becoming such, (A) has been and is suspended or expelled from a registered national or affiliated securities association, registered pursuant to Section 15A of the Act, or from a national securities exchange, registered pursuant to Section 6 of the Act, or has been and is barred or suspended from being associated with all members of such association or national securities exchange for violation of any rule of such registered securities association or national securities exchange which prohibits any act or transaction constituting conduct inconsistent with just and equitable principles of trade, or requires any act the omission of which constitutes conduct inconsistent with just and equitable principles of trade; or (B) is subject to an order of the Commission denying, suspending or revoking his registration pursuant to Section 15 of the Act, or expelling or suspending him from membership in a registered securities association or a national securities exchange, or barring or suspending him from being associated with a broker or dealer; or (C) by his conduct while associated with a broker or dealer, was a cause of any suspension, expulsion, or order of the character described in clauses (A) or (B), which is in effect with respect to such broker or dealer, or (D) has associated with him any person who is known, or in the exercise of reasonable care should be known, to him to be a person who, if such person were a broker or dealer, would be ineligible for admission to or continuance in membership under clauses (A), (B), or (C) of this section.

(b) No broker or dealer shall be admitted to or continued in membership in the Corporation if the Board of Governors deems it appropriate, unless the Commission directs otherwise in cases in which the Commission finds it appropriate in the public interest so to direct, if such broker or dealer,

whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated, has been and is suspended or expelled from a national securities exchange or has been and is barred or suspended from being associated with all members of such exchange, for violation of any rule of such exchange.

(c) In those cases where the Board of Governors deems it appropriate, no broker or dealer shall be admitted to or continued in membership in the Corporation if such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated, (A) has willfully made or caused to be made in any application or report filed with the Corporation, or in any proceeding before the Corporation with respect to membership or registration, any statement which was at the time and in light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein; or (B) has been convicted within the ten years preceding the filing of an application or at any time thereafter of any felony or misdemeanor which the Corporation finds involves the purchase or sale of any security or arises out of the conduct of the business of a broker, dealer or investment adviser; or which involves embezzlement, fraudulent conversion, or misappropriation of funds or securities, or which involves mail fraud, or fraud by wire, radio, or television; or, (C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, or dealer, or as an affiliated person or employee of any investment company, bank or insurance company, or from engaging in or continuing any conduct or practice in connection with such activity, or in connection with the purchase or sale of any security.

(d) No broker or dealer shall be admitted to or continued in membership and no natural person shall become or continue to be associated with a member, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest so to approve or direct, unless such broker or dealer or person associated with a member is qualified to become a member or a person associated with a member in conformity with specified and appropriate standards with respect to the training, experience, and such other qualifications as the Board of Governors finds necessary or desirable, and in the case of a member, the financial responsibility of such member.

In establishing and applying such standards, the Board of Governors may classify members and persons associated with such members, taking into account relevant matters including the type of business done and securities sold. The Board of Governors may specify that all or any portion of such standards shall be applicable to any such class and may require the persons in any such class to be registered with the Corporation.

Such classifications, qualifications, registration requirements, standards and exceptions thereto shall be incorporated in Schedule "C" attached to and made a part of these By-Laws. Within the limitations provided herein, the Board of Governors shall have the power to adopt, alter, amend, supplement or modify the provisions of Schedule "C" from time to time without recourse to the membership for approval, as would otherwise be required by Article IX hereof, and Schedule "C", as adopted, altered, amended, supplemented or modified, shall become effective as the Board of Governors may prescribe unless disapproved by the Commission.

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• • • *Explanation by the Board of Governors*

Details of Qualification Examination—Continued

SOUTH DAKOTA: Aberdeen, Rapid City
TENNESSEE: Memphis, Nashville
TEXAS: Abilene, Amarillo, Corpus Christi, Dallas, El Paso, Houston, San Antonio
UTAH: Salt Lake City
VERMONT: Montpelier
VIRGINIA: Norfolk, Roanoke
WASHINGTON: Seattle, Spokane
WEST VIRGINIA: Charleston
WISCONSIN: Green Bay
WYOMING: Casper

EXAMINATION CENTER HOLIDAYS

Examinations which fall on the following holidays will be given on the next full business day except as noted on the "Schedule of Examination Centers":

New Year's Day, January 1
Washington's Birthday, February, 3rd Monday
Good Friday
Memorial Day, May, Last Monday
Independence Day, July 4
Labor Day, September, 1st Monday
Columbus Day, October, 2nd Monday
Veteran's Day, October, 4th Monday
Election Day, November, 1st Tuesday after 1st Monday
Thanksgiving Day, November, 4th Thursday
Christmas Day, December 25

• • • *Resolution of the Board of Governors*

Similarity of Membership Names

No person or firm shall be admitted to membership in the Corporation having a name which is identical to the name of another member appearing on the membership roll of the Corporation or a name so similar to any such name as to tend to confuse or mislead.

No member shall be continued in membership in the Corporation if it changes its name to the name of another member appearing on the membership roll of the Corporation, or to a name so similar to any such name as to tend to confuse or mislead.

[Resolution adopted effective June 1, 1970.]

¶ 1103 Definitions

Sec 3. When used in these By-Laws, unless the context otherwise requires:

"Broker"

(a) The term "broker" means any individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization or other legal entity engaged in the business of effecting transactions in securities for the account of others, but does not include a bank.

"Dealer"

(b) The term "dealer" means any individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization or other legal entity engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.

"Investment banking or securities business"

(c) The term "investment banking or securities business" means the business, carried on by a broker or dealer, of underwriting or distributing issues of securities, or of purchasing securities and offering the same for sale as a dealer therein, or of purchasing and selling securities upon the order and for the account of others; provided, however, that the term "investment banking or securities business" shall not include transactions on regularly organized exchanges, but such term shall include all business relating to such transactions to the extent that such business is not conducted by a member of such exchange, or by any person or organization having the privilege of any such exchange for itself or any of its partners or executive officers.

"Member"

(d) The term "member" means either any broker or dealer admitted to membership in the Corporation or any officer or partner of such a member or, as provided in Section 5 of this Article, the executive representative of such a member or the substitute for such a representative.

"Bank"

(e) The term "bank" means (A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (C) any other banking institution, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under section 11 (k) of the Federal Reserve Act, as amended, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this title, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

"Person associated with a member"

(f) The term "person associated with a member" means every sole proprietor, partner, officer, director, or branch manager of any member, or any natural person occupying a similar status or performing similar functions, or any natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by such member, whether or not any such person is registered or exempt from registration with the Corporation pursuant to these By-Laws.

¶ 1104 Application for Membership

Sec. 4. (a) Application for membership in the Corporation, properly signed by the applicant, shall be made to the Board of Governors, on the form to be prescribed by the Board, and shall contain:

Membership agreement

(1) An acceptance of and an agreement to abide by, comply with, and adhere to, all the provisions, conditions, and covenants of the Certificate of Incorporation, the By-Laws, the rules and regulations of the Corporation as they are or may from time to time be adopted, changed or amended, and all rulings, orders, directions and decisions of, and penalties imposed by, the Board of Governors or any duly authorized committee; provided however, that such an agreement shall not be construed as a waiver by the applicant of any right to appeal as provided in the Act.

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IN THE UNITED STATES DISTRICT COURT

FOR THE SOUTHERN DISTRICT OF NEW YORK

ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs,

-against-

GEORGE A. CHESTNUTT, JR., et al.,

Defendants.

68 Civ. 2885 (I.B.W.)

BE IT REMEMBERED that, pursuant to Notice of Taking Deposition and on Thursday, the 24th day of May, 1973, commencing at the hour of 9:30 a.m. thereof, at the Pacific Coast Stock Exchange, 301 Pine Street, San Francisco, California, before me, RICHARD CORVILLE, a Notary Public in and for the City and County of San Francisco, State of California, there personally appeared

THOMAS P. PHELAN,

called as a witness by the plaintiffs herein, who, being by me first duly sworn, was thereupon examined and interrogated as is hereinafter set forth.

Messrs. POMERANTZ, LEVY, HAUDEK & BLOCK, 295 Madison Avenue, New York, New York 10017, by RICHARD M. MEYER, Esquire, appeared as counsel on behalf of the plaintiffs.

Messrs. ROGERS, HOGE & HILLS, 90 Park Avenue, New York, New York 10016, by CLENDON H. LEE, Esquire, appeared as counsel on behalf of the defendants.

Messrs. MUNGER, TOLLES, HILLS & RICKERSHAUSER, 606 South Hill Street, Los Angeles, California 90014, by CHARLES E. RICKERSHAUSER, JR Esquire, appeared as counsel on behalf of the Pacific Coast Stock Exchange.

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EXAMINATION BY MR. MEYER

MR. MEYER: Q. Mr. Phelan, would you please state your full name for the record, please.

A. Thomas P. Phelan. I live -- residence at 152 Bella Vista in Belvedere, California.

Q. What is your occupation?

A. I am the President of the Pacific ~~Coast~~ Stock Exchange.

Q. And how long have you been the President?

A. Since March the 15th, 1971.

Q. As President, is it your duty to enforce the rules of the Exchange? A. It's one of my duties, yes.

Q. And I take it you are familiar with the rules of the Exchange.

A. Fairly well, yes.

Q. Mr. Phelan, are you familiar with the rules which provide for approved nonmember status? A. Yes.

Q. Is approved nonmember status also referred to as preferred rate membership? A. Not membership -- preferred rate privilege.

Q. Preferred rate privilege. I take it the two terms are used interchangeably? A. We call it a preferred rate firm Provision is that they can't refer to this as a membership in the Exchange in any way.

Q. Uh-huh.

MR. LEE: At this point, Dick, may I put -- Mr. Meyer, at this point, may I put on the record our objection to the taking of the testimony of this witness as being totally irrelevant.

MR. MEYER: Q. How long has the Pacific Coast Exchange provided for approved nonmember status?

A. I can't recall the date, but it's roughly since about 1935, in the middle '30's.

MR. RICKERSHAUSER: Could we go off the record a second?

MR. MEYER: Surely.

(Discussion off the record.)

MR. MEYER: Q. To whom is the approved nonmember status available? A. It's available to members of other registered stock exchanges, members of the N.A.S.D. or ~~some of our~~ SECO organizations, or banks operating ~~under~~ within the continental limits of the United States.

Q. The rules of the Exchange provide for a discount to approved nonmembers; is that correct? A. Right.

Q. And what is that discount? A. 25 percent of the regular nonmember rate.

Q. And --

MR. LEE: May we have a pinpoint as to time here?

MR. MEYER: I'm looking at this --

MR. LEE: All right.

MR. MEYER: Q. How long has that been in effect?

A. Well, it's been in effect on the Pacific since its inception in 1957, and the predecessor Exchanges back into the '30's.

Q. And has it always been 25 percent? A. Yes.

Q. Now, I'm going to show you, Mr. Phelan, a copy of the Constitution and Rules of the Pacific Coast Stock Exchange. I'll not mark it, because this is my only copy. It's dated January, 1969. And direct your attention to Rule 4, Section 2, and ask you whether that is the provision to which you have reference when you refer to discounts to approved nonmembers? A. Yes.

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Q. Thank you.

I think, on second thought, I will mark that. All right, Reporter, please mark that as Plaintiffs' Phelan Exhibit No. 1.

(A booklet entitled Pacific Coast Stock Exchange, Constitution and Rules, January, 1969, was marked as Plaintiffs' Exhibit No. 1 for identification, and retained by Counsel.)

MR. MEYER: Q. Now, in addition to the discounts, was there available to approved nonmembers prior to December 5th, 1968, give-ups? A. Yes.

Q. And what portion of commissions could be given up to approved nonmembers? A. Same amount.

Q. 25 percent?

Now, I show you a two-page document taken from the Pacific Coast Stock Exchange Guide, prior to 1968, which I will ask the Reporter to mark as Plaintiffs' Exhibit No. 2.

(Photocopies of two pages entitled "Investment Fund Orders," pages 3091 and 3092, were marked as Plaintiffs' Exhibit No. 2 for identification, and retained by Counsel.)

MR. LEE: For the purpose of the record, Mr. Meyer, you stated that was prior to 1968. Is there any identifying date on any of the pages there which can give us a further identification?

MR. MEYER: The only identification is the CCH notation up here that says 5-68.

MR. LEE: Thank you.

MR. MEYER: Which indicate it was prepared in May, 1968.

Q. Mr. Phelan, this purports to be Rule 4, Section 5, of the Rules

of the Pacific Coast Stock Exchange. Prior to this amendment in December, 1968, can you look at that and tell me if you understand that to be correct?

A. I recall those rules.

Q. Now, give-ups are no longer available to approved nonmembers, is that correct, since December, 1968?

A. That's right.

Q. Discounts, however, still are; is that right?

A. That's right.

Q. If an approved nonmember receives a -- strike that. If prior to December, 1968, an approved nonmember had received a give-up, and the approved nonmember was an investment advisor of a mutual fund, would the Exchange have taken any action to preclude the approved nonmember from crediting the advisory fee of the mutual fund in an amount equivalent to the amount of the give-up?

MR. LEE: Objection as to the form of that question. Purely hypothetical.

MR. MEYER: You may answer.

A. As I understand your question, no, we would not object.

Q. I ask the Reporter to mark as Plaintiffs' Exhibit No. 3 a copy of the letter on the letterhead of the Pacific Coast Stock Exchange, over the signature of Mr. Phelan, to Mr. Caleb Loring, Jr., dated July 25, 1968.

(A photocopy of a letter to Mr. Caleb Loring, Jr., dated July 25, 1968, was marked as Plaintiffs' Exhibit No. 3 for identification, and retained by Counsel.)

MR. LEE: May I see the Exhibit after it's marked?

219a

(Pause while Counsel examines document.)

MR. MEYER: Q. Can you identify Plaintiffs' Exhibit No. 3, Mr. Phelan?

(Pause while Witness examines document.)

THE WITNESS: Yeah, looks like the letter, my signature.

MR. MEYER: Q. Was that --

A. A copy of it.

Q. -- prepared after consultation and advice with any members of the Board of Governors or with Counsel?

A. I don't recall.

May I see that letter again? I don't remember -- are you going to ask me something about the letter?

Q. Nothing further. A. Oh, all right.

Q. I'll ask the Reporter to mark as the next Exhibit a document on the letterhead of the Pacific Coast Stock Exchange, entitled "Preferred Rates of Commission."

(A photocopy of a one-page document entitled "Preferred Rates of Commission," Pacific Coast Stock Exchange, was marked as Plaintiffs' Exhibit No. 4 for identification, and retained by Counsel.)

MR. MEYER: Q. Can you identify that document, Mr. Phelan?

A. Uh-huh.

Q. Can you describe it, Mr. Phelan? What is it?

A. This is an announcement on our preferred rates of commission, and who's eligible for them, and how they're applicable, and just information generally on the use of that Rule.

Q. Is the application fee still the same?

220a

A. I don't recall. What is it there?

Q. $100 per year.

A. Yes -- wait a minute, wait a minute, wait a minute -- no, no, no. That's as of right now, you mean?

Q. Yes. A. No, that has been changed. And it is now a thousand dollars.

Q. When was that changed? A. This last year.

Q. Prior to that, it had been a hundred dollars? A. Right.

Q. Is that each year, or is that an initial fee?

A. That's each year.

Q. With respect to discounts, does the Exchange take the same position which you stated that they took before, with respect to give-ups? Namely, that they do not preclude an approved nonmember who is an investment advisor of a mutual fund from crediting his advisory fee charged the mutual fund with an amount equivalent to the amount of discount?

MR. LEE: Objection to the form of the question.

MR. MEYER: You may answer.

A. We won't have any objection.

Q. If an applicant for approved nonmember status is a member of the N.E.S.D., does the Exchange make any distinction as to whether the applicant advises a load fund or a no-load fund?

MR. LEE: Objection to the form of the question.

MR. MEYER: You may answer.

A. No.

Q. I have no further questions.

- - -

EXAMINATION BY MR. LEE

221a

MR. LEE: Q. Mr. Phelan, I invite your attention to Section 1 of Article VII of your Constitution as set forth in Plaintiffs' Exhibit No. 1 Phelan, which is the January, 1969 edition. And for purposes of the record, I will read that Section 1, and then show it to you.

It's also marked by "CCH" as paragraph no. 14018, under the caption, quote, "Eligibility," unquote. It states, Section 1, "Membership in this Exchange shall be limited to individuals who must be at least 21 (twenty-one) years of age and citizen of the United States, and whose chief business is that of transacting business as a broker or dealer in securities," close quote.

I show you that, Mr. Phelan, and ask you whether prior to January, 1969, that was substantially the description of eligibility for the preceding several years in your Constitution?

MR. MEYER: Eligibility for --

MR. LEE: Eligibility for membership.

THE WITNESS: Yes, I would say that's true.

Q. And I show you what your Counsel has kindly handed to me, a copy of your Constitution and Rules, bearing the date of April, 1972, and show you the identical section which, I believe, leaves out the words referring to citizens of the United States, and ask you whether the provision that I've just read from Plaintiffs' Exhibit No. 1 is substantially the same today in your Rules.

(Pause while Witness examines document.)

THE WITNESS: Yes.

MR. LEE: No further questions.

(Signature)

EXHIBIT 2 for id
ESS
RTER
8-24-73

¶ 3990

Investment Fund Orders

SEC. 5. Members and member firms may accept orders for execution on the Exchange from Investment Funds, registered under the Investment Company Act of 1940, on a give-up basis to include other members and approved non-members entitled to Preferred Rates of Commission but strictly subject to the following conditions:

¶ 3995

Designate Give-up

SEC. 5(a). The Investment Fund shall in each instance, at the time the order is placed, designate it specifically as one to include on a give-up basis either (a) other members, (b) approved non-members or (c) both other members and approved non-members.

¶ 4000

Give-up for Member

SEC. 5(b). (1) If the order is designated as one to be executed on a give-up basis for members, the executing member may credit not to exceed 70% of the commission earned to a special account to be identified in the member's records as "Member's Investment Fund Give-up Account."

Amended
December 12, 1962

Give-up Approved Non-Member

SEC. 5(b). (2) If the order is designated as one to be executed on a give-up basis for approved non-members, the executing member may credit not to exceed 25% of the commission earned to a special account to be identified in the member's records as "Approved Non-Member's Investment Fund Give-up Account."

Give-up Members and Approved Non-Members

SEC. 5(b). (3) If the order is designated as one to be executed on a give-up basis for both members and approved non-members, the executing member may credit not to exceed 70% of the commissions earned to the respective special give-up accounts provided for in Sections 5(b)(1) and 5(b)(2) hereof provided not more than 25% of the commission as set forth in Section 1 of this Rule is credited to said special non-member's give-up account and the remainder credited to said special member's give-up account.

Amended
December 12, 1962

INTENTIONALLY OMITTED

4091

PACIFIC COAST STOCK EXCHANGE

618 So. Spring Street
Los Angeles 90014

OFFICE OF THE PRESIDENT

301 Pine Street
San Francisco 94104

Los Angeles
July 25, 1968

Mr. Caleb Loring, Jr.
Vice President-General Counsel
Fidelity Management & Research Company
35 Congress Street
Boston, Massachusetts 02109

Dear Mr. Loring:

Reference is made to your letter of May 27 and our reply of June 10 concerning the application of The Crosby Corporation for the Preferred Rates of Commission on the Pacific Coast Stock Exchange.

You requested our interpretation of the condition on the application which states,

> "The applicant will not directly or indirectly extend or grant the Preferred Commission Rate to another not approved by the Exchange to receive such rate".

We have interpreted this provision as not precluding any of our members receiving "give-ups" from adjusting the management fees for funds they manage to a degree proportionate with the amount of the "give-ups" received, and the same interpretation would be applicable to preferred rate firms.

Accordingly, we are pleased to confirm that The Crosby Corporation has been approved as a firm eligible for the Preferred Rates of Commission. It is to be understood that of the regular non-member commissions paid by the "Fidelity Group" Funds to any of our members on transactions on the Pacific Coast Stock Exchange 25% may be directed to The Crosby Corporation as provided by our Rule IV, Section 5. If the orders are placed through The Crosby Corporation and The Crosby Corporation confirms to the "Fidelity Group" Funds, it will be obligated to charge the full non-member rate of commission. In turn, the member firm that executes such orders need charge The Crosby Corporation only 75% of such non-member rates.

4082

Mr. Caleb Loring, Jr. - 2 July 25, 1968

The Exchange does not purport to exercise any control over the management fee charged by the Fidelity Management & Research Company to the "Fidelity Group" or the adjustment of fees by virtue of its increased earnings from "give-ups" received by The Crosby Corporation, its wholly owned subsidiary.

Approval of the preferred rate application is being considered effective as of July 25, 1968 and will be applicable to all orders executed on and after that date. The fee for the balance of the calendar year is $50. Since a check for $70 was enclosed with the application, we are arranging for our accounting office to remit a refund in the amount of $20.

Enclosed is a list of firms entitled to the Preferred Rate. A supplement will be issued at a later date and will include the name of The Crosby Corporation. We shall also place that firm's name on our mailing list to receive revised copies of our directories, preferred rate lists and various other Exchange publications.

Should you have any questions on the foregoing, kindly advise us.

Yours very truly,

Thomas P. Phelan

Enc.

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs,

-against-

GEORGE A. CHESTNUTT, et al.,

Defendants.

68 Civ. 2855

Deposition of STANLEY LAW SABEL, taken by plaintiffs pursuant to notice, at the offices of American Investors Fund, 88 Field Point Road, Greenwich, Connecticut, on June 8, 1973, at 10:00 a.m., before Fred Lorber, a Certified Shorthand Reporter and Notary Public of the State of New York.

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PHONE: 349-5790

227a

Investment Advisor, even as he's receiving the information?

A Yes, he makes use of the Investment Advisor's material prepared by others.

MR. LEE: I think, for the purpose of the record, again, Mr. Krasner, it might be noted that Mr. Sabel has not been directly involved as a trader or a chart keeper, either one, but his functions have been very different.

Q Mr. Sabel, you have seen this volume which we refer to in shorthand as PPI?

A Sure.

Q When did you first see it, sir?

A About the time it came out. If you want my best recollection as to when it came out, I'll give it to you.

Q No.

A I'll say 1966.

Q Came out in December, 1966.

A I hit the year right, anyhow.

Q You saw it shortly after it came out?

A Yes.

Q You read it from cover to cover?

A I certainly did.

Q You never heard of that status, is that correct?

A No.

Q Have you heard o[illegible]s?

A Oh, yes.

Q When did you first hear of it, sir?

A When I read the deposition that you had taken of -- in California.

Q Read Mr. Phelan's deposition?

A Yes.

Q Prior to that time, you had never heard of that?

A No.

Q Did you ever discuss this matter with Mr. Lee, prior to reading Mr. Phelan's deposition?

A No.

Q Did you ever discuss it with anyone at Mr. Koegel's firm?

A No. I'm not sure today, that that status would have been available anyhow. It was limited to who could get it. It wasn't everybody that could get it.

Q What is your understanding, as to who it was limited to, sir?

MR. LEE: I think if you are going to

Q Have you ever examined the rules of the Philadelphia Exchange?

A Only in one particular, not -- you're interested in -- what I examined was the fact that they allowed customers' men not to work full-time. Whereas, the New York Stock Exchange, their registered representatives have to be full-time employees. Which offered a little flexibility, which other exchanges didn't have.

Q Did you ever read the rules with an eye towards whether the fund could become a member of the Philadelphia Exchange?

A No.

Q Did you ever discuss that subject with anyone?

A No.

MR. KRASNER: Mr. Sabel, I don't believe I have any further questions, subject to one proviso; and that is, should it turn out that this exchange of letters that you have testified about is different than -- the letters themselves are different from what I understand them to be from your testimony today, that I may seek to recall you. But aside from that, I have

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

----------x

ROSALIND FOGEL and GERALD FOGEL, :

Plaintiffs, :

-against- : INDEX NO. 68 Civ. 2855

GEORGE A. CHESTNUTT, JR., et al., :

Defendants. :

----------x

Deposition of defendant GEORGE A. CHESTNUTT, JR., taken by plaintiffs, pursuant to notice, at the offices of Messrs. Pomerantz, Levy, Haudek & Block, 295 Madison Avenue, New York, N. Y. 10017, on May 14, 1973 at 10:15 a.m., before William Blitz, a Certified Shorthand Reporter and Notary Public of the State of New York.

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which have recaptured brokerage commissions?

A Yes.

Q When did you first become aware of these recapture possibilities with respect to other funds?

MR. LEE: With respect to load funds?

MR. KRASNER: Load funds, if you wish.

A Oh, I must have been aware of it ten years ago. I don't--maybe you can tell me when Kansas City Securities was organized. Because I recall having asked at that time is there any possibility that we could go that route and form a brokerage subsidiary. And that was a long time ago. I don't remember how long ago.

Q That was in 1965, sir.

A It was much longer than that, I think. Is that when Kansas City Securities first started business?

Q The exhibits in this litigation which include portions of New York Times and Wall Street Journal articles indicate that some time around January of 1965 Waddell & Reed organized a brokerage affiliate which became a member of the Pacific Coast Stock Exchange.

So you recall discussing with Mr. Sabel in approximately January of 1965 the possibility of recapturing brokerage commissions?

MR. LEE: I don't think the witness

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

----------x

ROSALIND FOGEL and GERALD FOGEL, :

Plaintiffs, :

-against- :

GEORGE A. CHESTNUTT, JR., et al., :

Defendants. :

----------x

Deposition of defendant GEORGE A. CHESTNUTT, JR. taken by plaintiffs pursuant to notice and stipulation, at the offices of Messrs. Pomerantz Levy Haudek & Block, 295 Madison Avenue, New York, N. Y. 10017, on October 17, 1967, at 10:45 a.m., before Ruth Kleinman, a Shorthand Reporter and Notary Public of the State of New York.

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NEW YORK, N. Y. 10038
WORTH 4-3567

there are some differences between the figures supplied in Answer No. 8 and those supplied in the responses of Jesup & Lamont in their interrogatories.

BY MR. MEYER:

Q Are you aware of that, Mr. Chestnutt?

A No.

MR. LEE: I have noticed that too, Mr. Meyer, and I don't know whether I can account for all of that, but when the full year figures are taken in, and they are not too far apart, it may be that some of that has to do with shifting of periods.

The Fund accrues brokerage expense on the basis of the date of the trade and I believe probably the brokerage firm, although I am not in any position to speak for it, carries its books on the settlement date basis and that may account for part of it.

There may be some other slight adjustments to be made, but I don't know what those would be.

Q With reference to Exhibit A to your answers to the interrogatories, I notice that there is a substantial increase in the number of employees for the

year 1966 as opposed to the first quarter of 1967.

I think I stated that backwards.

The point is, there are more employees in the first quarter of 1967 than 1966, substantially more, in fact.

Who prepared this list of employees?

MR. LEE: I can state for the record if you would like for me to state, Mr. Meyer, who prepared it because I know who prepared it and I don't know whether the witness does. If you want his recollection or his knowledge I have no objection to your asking him.

MR. MEYER: Go ahead.

MR. LEE: This list was prepared at my request by Mr. Lee Glardon. I don't know that Mr.Chestnutt has ever seen it except in thumbing through these responses after they were served and filed.

Q Do you know,Mr. Chestnutt, whether all these people are fulltime employees?

A Not offhand. If I looked at the list--I don't know if I can tell even after looking at the list.

(Witness examines document.)

Q I am speaking of the 1966 year now.

MR. LEE: I thought you were speaking of 1967.

MR. MEYER: It doesn't matter but let's talk about 1966 so we have a point of reference.

A You mean, of course, as of the time that this was estimated?

Q That's correct.

A Because I recognize already one person who is no longer with us. Many of these names I couldn't tell whether they were fulltime or parttime. I have no direct dealings with them.

Q During 1966 did any of these employees spend all their working hours in connection with the investment advisory services to American Investors Fund?

MR. LEE: Are you restricting that to advisory services and not any other services?

MR. MEYER: Anything pursuant to the investment advisory agreement.

MR. LEE: Which, of course, as you understand, provides the furnishing of a building, and furnishing of complete management services.

Do you want to know whether there are any of them, for example, some might have dealt solely with the mailing lists for The Fund, something

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director?

A Mr. Ware.

Q Did you know Mr. Radcliffe prior to that time?

A No.

Q Who first suggested that Mr. Veeder become a director?

A Mr. Sabel.

Q Had you known Mr. Veeder prior to that time?

A No.

Q Have I omitted any present directors of The Fund or does that cover the board?

MR. LEE: Yes. You have omitted Mr. Greene.

Q Who first suggested that Mr. Greene become a director?

A I did.

Q How long had you known Mr. Greene?

A About four years.

(Whereupon, at 12:50 p.m., a luncheon recess was taken.)

A As a matter of business judgment, I never saw any advantage for either the fund or Chestnutt Corporation doing so.

Q Did you ever inquire of the NASD whether Chestnutt Corporation could become a member?

A No.

Q Do you know of any rule of the NASD that would keep Chestnutt Corporation from becoming a member?

A No.

MR. LEE: I object. Well, he has already answered it.

Q Could you tell me what the business reasons are for your not joining the NASD?

MR. LEE: Iobject to that, Mr. Krasner. That's not in issue in this case. If you will show me anything that Judge Palmieri has ruled on which would suggest that the witness ought to answer that question, it might obviate my objection.

MR. KLOTZ: Can you repeat the question, please?

(The question was read.)

MR. LEE: I will permit the witness to answer the question over my objection.

THE WITNESS: What is the question now?

the question.

(The pending question was read.)

A I don't know of any way that that could be done.

Q You say you don't know of any way that could be done. So that you believe--

A Not directly. You could do it by devious methods as were described earlier, becoming an NASD member and directing business to your subsidiary who is a member or some devious way like that. But not directly.

Q Would it cost Chestnutt Corporation anything in dollars if it did reduce the advisory fees as a result of crediting brokerage?

MR. LEE: I object to that question as being absolutely unanswerable. You are suggesting that if Chestnutt Corporation were an entirely different business from the business that it is in, if some dollar result would follow. I think it is so completely hypothetical.

MR. KRASNER: I will try it again.

BY MR. KRASNER:

Q Mr. Chestnutt, when American--when and if Chestnutt Corporation were to reduce the advisory fee

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

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ROSALIND FOGEL and GERALD FOGEL, :

Plaintiffs, :

-against- : 68 Civ. 2855

GEORGE A. CHESTNUTT, et al., :

Defendants. :

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Deposition of defendant GEORGE A. CHESTNUTT, by WARREN K. GREENE, taken by plaintiffs, pursuant to notice, at the offices of Messrs. Pomerantz Levy Haudek & Block, 295 Madison Avenue, New York, N. Y. 10007 on May 8, 1973 at 10:15 a.m., before Sandra Miaskoff, a Shorthand Reporter and Notary Public of the State of New York.

BLITZ-LORBER REPORTING CO.
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funds which have joined regional exchanges, are you not?

A I'm aware of the fact that certain mutual funds have affiliates which are in the brokerage business. And have joined various stock exchanges to effect brokerage business.

Q You are aware also of the fact that many of these brokerage affiliates use their membership to recapture commissions for the mutual fund, are you not?

A I have heard, and I know, that certain of them transact their own brokerage business. And in some instances have reduced their management fees or some other device by the amount of the net profits of those brokerage firms.

Q When did you become aware of these facts?

A Well, I've heard Kansas City Securities for some time. It may be even longer than--maybe ten years ago. I think I was aware of Kansas City Securities while I was with the First Boston Corporation.

Q Were you aware of the fact that Kansas City Securities was recapturing brokerage commissions for the United Funds group?

MR. LEE: Why don't you state for the record why the word "recapture" came into the

Q What are the qualifications?

A Well, the qualifications?

A Well, the qualifications are such that one has to be a broker or a dealer and do business in the securities business.

Q Have to do business with the public?

A Well, it doesn't necessarily mean public. The public is a rather vague term. There are NASD members which are, say, over-the-counter dealers. They don't deal with the public, but they deal with other NASD members. In the brokerage business you have to be an NASD member in order to participate in the brokerage and underwriting business.

Q It's your understanding, Mr. Greene, that if I wanted to become an NASD member of getting give-ups when they were permitted that I would be refused membership?

A Yes.

Q How did you get this understanding, Mr. Greene?

A Well, I've had this understanding for some time. As I pointed out, the firm that I previously worked for, the First Boston Corporation, was an NASD member. During my training program at that firm, which

lasted over 18 months, we studied the rules and regulations, methods of operations, constitution, et cetera, of the NASD. It was an integral part of our training program.

Q Who told you or how did you come to learn that the NASD would require that somebody be in the brokerage business and that they not simply be registered as a broker-dealer for the purposes of recapturing commissions?

A Well, as a result of my training program my knowledge of the NASD, I became--well, I didn't become, I was indoctrinated with the idea that an NASD member is a member in the brokerage business or acting as a dealer in securities. I was never given any kind of impression or insight in my experience as a registered representative of an NASD member firm, that a corporation could be an NASD member for the sole purpose of collecting checks from other brokers. It just did not seem at all reasonable.

Q Did you ever make any inquiry of anybody as to whether that was permissible?

A I didn't make any inquiry because I was knowledgeable about the NASD. As I said, I was with an NASD member firm for almost five years. I was familiar

with the rules and constitutions.

Q Did Mr. Lee or anybody else ever inform you that an affiliate of the Fund or of the investment advisor could not become an NASD member for the purpose of recapturing commissions?

A Well, no one needed to inform me of anything like that. When I joined with Mr. Chestnutt's organization I was aware of the fact that they were a no-load mutual fund. That they were not a member of the NASD, they did not participate or engage in the securities business in the sense that they were a brokerage firm dealing with the public. They were a customer of the brokers and dealers.

In fact, American Investors Fund was a customer of mine.

Q But, Mr. Greene, you never felt it incumbent upon yourself to pick up a telephone and call general counsel for the NASD or anybody else at the NASD to find out whether your information was correct, did you?

A As I say, I was familiar with the basic framework of the NASD. I was familiar with the basic framework of the Chestnutt organization and American Investors Fund. American Investors Fund is a customer of the brokerage business. I knew that they were not

contemplating going into the brokerage business. I didn't want to be in the brokerage business. I had left the brokerage business to join the Chestnutt Corporation. In other words, to go on the other side of the fence.

Q Mr. Greene, I understand that. Would you have considered it going into the brokerage business to take checks as they came in the mail from--in the form of give-ups?

MR.LEE: Are you suggesting here, Mr. Krasner, that all that was necessary was to form a shell corporation of some kind and pluck the fruits of give-ups?

MR. KRASNER: I so suggested in the past, Mr. Lee.

MR. LEE: But not with this witness. I just want to clear on the record that you think the subterfuge of forming a paper organization was all that was necessary to have money like manna from heaven to drop into the coffers of the Fund?

MR. KRASNER: I wouldn't call it subterfuge, Mr. Lee. I would call it a legal and fiduciary obligation of each and every investment advisor to form such a subsidiary.

MR. LEE: And to go in the brokerage

MR. LEE: You are misstating--he stated that he was familiar with the NASD rules and its eligibility requirements. You are changing it to say recapture.

Q Did you ever investigate whether a brokerage affiliate of the Fund of the investment advisor could be formed which could qualify for membership on the NASD solely for the purpose of recapture?

A My understanding of the NASD was such that the NASD would not have allowed admission of a firm for the express purpose of merely collecting checks from other brokers. That would defeat the whole idea of the NASD. The NASD is a national association of securities dealers. Certainly one would not even be qualified in the name to merely collect checks. It would have been the National Association of Check Collectors.

Q Mr. Greene, did you ever inquire from anyone at the NASD whether in fact they had such a rule against membership by an affiliate of an investment advisor for the purpose of recapture?

A I made no specific inquiry.

Q This was based on some general understanding that you carried with you from the First Boston Corporation, is that right?

Q In any event, it would have been one of those two persons, is that it?

A Yes.

Q There was no time at which the directors of the Fund ever requested the assistance of outside counsel aside from Mr. Lee or Mr. Sabel?

A I don't know of any instance that the outside directors arranged for outside counsel other than Mr. Lee who is somewhat outside the Fund.

Q Mr. Lee is also counsel for the investment advisor, is he not?

A Yes.

Q So that Mr. Lee may be considered to be in conflict of interests since he represents both the Fund and the investment advisor?

MR. LEE: I object to that and move to strike conflict of interests. You know perfectly well that in this litigation the Fund is separately represented.

Q I also asked Mr. Greene if the Fund ever requested outside counsel with respect to the question of recapture.

A To my knowledge, the outside directors nor the inside directors engaged or spoke with any other counsel.

Although they might have been formed--

Q It's a fact, Mr. Green, is it not, that the Fund retained Royall, Koegel & Wells as its counsel in this litigation.

A That's a fact.

Q And Royall, Koegel & Wells I assume was retained after a vote by the directors?

A I would assume so. That would be in the minutes.

Q Mr. Greene, have the directors of the Fund ever requested Royall, Koegel & Wells to investigate whether it was possible for the Fund to recapture commissions?

MR. LEE: You are talking about a resolution by the board?

MR. KRASNER: I don't care if it was formal or informal.

MRS. KARMEL: Are you speaking of 1968 or in connection with the defense of this litigation?

MR. KRASNER: Any connection from 1968 to date.

A I don't believe the--

MRS. KARMEL: I would object to any

answer to this question which would bring into play any work which Royall, Koegel &Wells has done for the Fund in connection with the defense of this litigation. If you limit your question to any investigation during the period of time you are talking about, that's a different matter.

MR. KRASNER: I am quite sure that you intend to interpose the direction of--the objection of attorney client privilege.

MRS. KARMEL: I just think your question is very unclear. I would like it clarified.

MR. KRASNER: I am being very specific. I am saying whether the directors of the Fund ever requested Royall, Koegel & Wells as attorneys for the Fund to investigate whether it was possible for the Fund to recapture brokerage commissions.

A As I understand it, Royall, Koegel is counsel to the Fund in this action. They were retained by the Fund by resolution of the board of directors.

Q Mr. Greene, I don't want to cut you off. My question is really one of fact, have they or haven't they done it? The question can be answered yes or no.

A No.

Q In other words, Mr. Greene, the directors of the Fund, to your knowledge, have relied on the representations made to them by Messrs. Sabel and Lee with respect to the question of the applicability of proposed Rule 10b-10 and the possibility of recapture?

A I and the board of directors of the Fund have relied on the opinions of Mr. Sabel and Mr. Lee in regard to the fact that the Fund nor the Chestnutt Corporation could join the NASD, is that because we were a no-load fund, with no dealer organization, or underwriting affiliate, we were just plain not eligible.

Q To the best of your recollection, Mr. Greene, there never came a time that any director of the Fund ever requested the advice of Mr. Lee or Mr. Sabel in connection with the possibility of becoming an NASD member?

A As I said before, this matter was taken up in board meetings at which time the directors were perfectly able to question or inquire at length.

Q I am not asking you whether they were able to. I'm asking you whether they did.

A Well, something of this nature would be discussed in an open manner. I don't--nothing like this, of course, was on an agenda but was discussed in

the general context of our overall business, our method of doing business.

Q Did the directors ever suggest that maybe Mr. Sabel or Mr. Lee ought to write a letter to the NASD to find out whether in fact you did qualify?

A No.

Q To the best of your knowledge no such letter was ever written, was it?

A No such letter was written.

Q To the best of your knowledge--to the best of your recollection did any of the directors suggest that somebody ought to telephone the NASD?

A I believe most of the directors were against our forming a brokerage affiliate and joining the NASD.

Q Didn't the directors want to have all the facts before they made up their mind?

A Well, a number of our directors were knowledgeable people and are knowledeable people. It doesn't take very long to understand the simple fact of the matter that we were a no-load fund, we did not wish to engage in the securities business, we did not wish to become a broker, we wished to be--we wished to continue to sell the Fund at net asset value to the public.

Now, I suppose that any of the directors

could have called the NASD themselves.

Q Did any of them ever call the NASD?

A I don't--not to my knowledge. But all they had to do was to pick up the phone.

Q To the best of your knowledge nobody ever did, right?

A To the best of my knowledge no one ever did because to the best of my knowledge none of the directors thought we should be in the brokerage business.

Q To the best of your recollection, Mr. Sabel told them they didn't qualify, right?

A Yes. I previously testified to that.

Q Once they were told that, they didn't pursue it any further, correct?

A A number of the directors, if not all the directors, were totally against our being involved in the securities business.

Q How did they express that?

A And I think that fact is in the record already.

Q How did they express this fact?

A I believe that has been expressed in the record, in the testimony of other directors that you have taken.

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

Securities Exchange Act of 1934
Release No. 8239

The Securities and Exchange Commission announced that the New York Stock Exchange has submitted for Commission comment and reaction the outlines of a proposal for certain revisions of its commission rate structure. A copy of that proposal is attached to this release. As described more fully below, the Exchange proposal generally contemplates (1) provision for a volume discount in commissions, (2) access to the exchange market for qualified nonmember broker-dealers through a professional discount, (3) recognition of limited customer directed "give-ups" of commissions to both members and nonmembers on New York Stock Exchange executions and limitations upon reciprocal business, (4) a prohibition of procedures by which institutional investors may recapture a portion of the commissions paid by them and (5) a requirement that the regional exchanges impose similar restrictions.

The Commission also announced that it has under consideration a proposal to adopt Rule 10b-10 under the Securities Exchange Act of 1934. The rule, essentially, would prohibit investment company managers from directing brokers executing transactions for an investment company to divide their compensation in any way with other brokers unless the benefits of such division accrue to the investment company and its shareholders. The rule would be adopted pursuant to the antifraud provisions of the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 and certain provisions of the Investment Company Act of 1940.

Since the proposal of the Exchange as well as the proposed Commission rule would have significant impact upon New York Stock Exchange member firms, nonmember broker-dealers, institutional investors, other exchanges and the public, the Commission believes it appropriate that all interested persons have an opportunity to comment not only on the proposed Commission rule but also on the Exchange's proposal.

Both the proposed Commission rule and the proposal of the Exchange arise out of certain problems presented by the great increase in institutional investment and the complex and rapidly developing pattern of practices and procedures in the securities markets associated with that increase which are commonly referred to as "give-ups and reciprocal business." Proposed Rule 10b-10 is limited in scope. It assumes that present give-up practices will continue and accordingly deals primarily with the question of conduct by fiduciaries in that context. The New York Stock Exchange proposal is more far reaching and, particularly insofar as it involves a volume discount, suggests the possibility that the problem with which the proposed rule is concerned could be dealt with in a more direct and thorough-going way by changing the commission rate structure. For this reason and because in certain respects the proposed rule of the Commission and the Exchange proposal are inconsistent, the Commission further believes it appropriate to afford interested persons the opportunity not only to comment with respect to both the proposed rule and the Exchange proposal but to suggest, if they so desire, alternative means of dealing with the serious and difficult problems presented.

Any consideration, both of these proposals and of the practices and procedures to which they relate, must include careful attention to their impact upon competition, including competition among securities firms, competition among markets and competition among institutional investors. This is mandated by the antitrust laws and the policies underlying these laws. As the Supreme Court has pointed out, the Exchange commission rate structure includes a number of practices which would clearly violate the antitrust laws absent the Securities Exchange Act and notwithstanding the Securities Exchange Act the exchanges do not enjoy a blanket exemption from the antitrust laws. Nevertheless where the Commission has jurisdiction to review and pass upon particular Exchange activities, as it has in the area of commission rates under Section 19(b) of the Exchange Act, antitrust immunity may, under some circumstances,

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be implied. 1/ Such immunity would be implied to the extent necessary to reconcile the statutory scheme of the Securities Exchange Act with that of the antitrust laws. This necessarily contemplates that full consideration be given to the policies of the antitrust laws as well as those of the Securities Exchange Act in evaluating any aspect of the commission rate structure or any proposals for its revision. Whether or not the mere existence of Commission jurisdiction necessarily creates an immunity from the antitrust laws was left open by the Supreme Court in the Silver case. However this may be, it is clear that antitrust considerations should receive the closest scrutiny.

BACKGROUND

The Commission believes it useful to outline briefly the situation which prompted both the New York Stock Exchange's rate structure proposal and proposed Commission Rule 10b-10 with the expectation that this may contribute to understanding and analysis of these proposals.

In recent years institutional investors, including banks, insurance companies, pension plans and investment companies have accounted for a steadily increasing share of the volume of trading on the exchanges. On the New York Stock Exchange institutional volume as a percent of total public volume has increased from 25.4 percent in March 1956 to 33.8 percent in September 1961, to 39.3 percent in March 1965 and 42.9 percent in October 1966, the latest date available. It should be recognized that these institutional investors usually represent a pooling, under professional management, of savings belonging to a great many individuals, most of whom are small investors. Consequently securities market conditions and practices which affect the investments of these individuals are of wide public interest.

These institutions tend to deal in larger blocks of securities than individual investors ordinarily do. Consequently increasing institutional participation in the exchange markets has been accompanied by a significant increase in the number of large blocks offered and traded. Studies by the New York Stock Exchange show that the number of transactions involving 10,000 shares or more has increased from 2171 in 1965 to 6685 in 1967, that the number of shares involved in these transactions has more than tripled, and that their share of reported volume has increased from 3.1 percent to 6.5 percent.

This situation has thrown an increasing strain on the rigid minimum commission rate structure, adopted many years ago by the New York Stock Exchange and followed by all other national securities exchanges, which is based upon a single round lot, usually 100 shares. There is no volume discount based either on the size of the individual order or upon the amount of portfolio business done by an institutional order or upon the amount of portfolio business done by an institutional investor over a period of time. Thus the commission which a member firm is required by Exchange rules to charge its customer on a 10,000 share transaction is 100 times the commission it is required to charge on a 100 share transaction and the commission on 100,000 shares is 1000 times the commission on 100 shares. Ostensibly all persons who are not Exchange members must pay the minimum commission. There is no distinction among different kinds of nonmember, e.g., nonmember brokers, individual customers, institutional investors, etc.

While orders to buy or sell large blocks involve greater demands on a broker than the execution of a single round lot order, it does not cost a broker anywhere near 100 times as much to execute a 10,000 share order than to execute a 100 share order. Indeed, for certain aspects of the execution process, such as bookkeeping, the cost is essentially the same. As is true in other areas of the business world, broker-dealers engaged in effecting such transactions have enjoyed the great advantages of scale accruing from large transactions. These institutional transactions generally do not involve the payment of a commission to a salesman of the broker, although an institutional brokerage business usually does entail the expense of maintaining an

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1/ Silver v. New York Stock Exchange, 373 U.S. 341 (1963). See also Kaplan v. Lehman Bros., et al., 250 F. Supp. 562 (N.D. Ill., 1966), aff'd 371 F. 2d 409 (C.A. 7, 1967), certiorari denied, ___ U.S. ___, the Chief Justice dissenting, (1967).

institutional trading department and the development of special talents. Consequently, the executing brokers are willing to accept substantially less compensation for executing institutional orders, particularly large institutional orders, than is contemplated by mechanical application of the existing minimum commission rate rules of the exchanges.

Managers of institutional investors have taken advantage of the competition among brokers for institutional business, and the willingness of such brokers to accept compensation far lower than that contemplated by the Exchange rules, to divert or recapture portions of the commission paid on institutional orders. An increasingly complex pattern of practices having this objective has developed. Many of these practices involve the so-called "give-up."

A "give-up" is a payment by the executing broker to other broker-dealers of a part of the minimum commission he is required to charge his customers. Under the rules of the stock exchanges, the payment may be made on the executing broker's own initiative and for his own purposes or it may be directed by the customer. The recipient of a "give-up" check may have had nothing whatsoever to do with the transaction for which the commission is charged and in fact may not even know of the transaction or where or when it was executed. Thus "give-ups" have been widely used in connection with mutual fund portfolio transactions. Managers of mutual funds direct give-ups, for the most part to broker-dealers who have sold fund shares in order to motivate, or reward, such sales effort. On certain orders, the executing broker may retain as little as 25 percent of the commission paid by the fund and give up the balance. Brokers who sell fund shares are thus compensated for their efforts not only by receipt of the dealer's portion of the "sales load" but also by substantial amounts of give-up dollars generated at the direction of the manager of the fund through purchases and sales of fund portfolio securities. Fund managers also often use give-ups as a reward for research ideas furnished to them in their capacity as investment advisers to the funds.

While the New York Stock Exchange permits its members to give up commissions only to other members of that Exchange, the smaller regional exchanges have, with increasing success, competed with the New York Stock Exchange for institutional business, particularly the business of mutual funds, by permitting give-ups of commissions not only to members of the particular exchange but also to any member of the National Association of Securities Dealers, Inc. or even to any registered broker-dealer. By requiring that an order be taken to a regional exchange, a mutual fund manager is able to provide monetary reward to broker-dealers who sell shares of the mutual fund but who are not members of the New York or of any exchange.

Give-ups are widely used in connection with so-called "cross" transactions. These involve situations where the order cannot be adequately executed in the auction process on the floor of an exchange and therefore the institutional broker finds the other side of the trade off the floor, i.e., locates a seller if he has an order to buy or a buyer if he has an order to sell, and then merely records or "crosses" the order on the floor. Exchange rules do not allow member brokers to consummate crosses in their offices or in the over-the-counter market at a negotiated commission, but they do allow the broker to send the transaction to any exchange of which he is a member and to give up from the commissions he must charge on the cross in accordance with the rules of that exchange. By this means large institutional orders can, nominally at least, be executed on small regional exchanges, but where this occurs the usual motive is simply to take advantage of the rules of that exchange with respect to the classes of persons who may receive give-ups.

In addition to the give-up, there have developed complex practices by which executing brokers provide compensation at the direction of institutional investors to other brokers by means of reciprocal business, i.e., permitting such other brokers to participate in the commission generated from execution, in the over-the-counter market or on regional exchanges, of orders which the institutional broker has received from other customers. More recently, certain member firms of the New York Stock Exchange have developed a procedure whereby they can compensate nonmembers of the New York Stock Exchange at the direction of mutual fund managers by paying cash to such nonmembers and crediting such payments on over-the-counter trades for unrelated customers, whether or not commissions were in fact charged on such trades. The compensated dealers have no

participation in these trades and, in fact, may never have heard of the trades at the time when they were executed.

Give-ups and reciprocal business practices in connection with institutional trading have become so widespread that it may plausibly be argued that, in the case of large institutional orders, there is in economic substance no fixed minimum commission. Commissions are negotiated between institutional managers and their "lead" brokers with the lead broker on occasion retaining no more than 25 percent of the ostensible minimum commission. This situation is perhaps most strikingly illustrated by procedures which have been developed and which enable institutional investors to recapture a portion of commissions for themselves. Many mutual fund managers have affiliates which are registered as broker-dealers; many of these affiliates are members of the NASD. A small number of mutual fund managers have created affiliates which have joined a regional stock exchange. In the latter situations, the manager directs that give-ups and reciprocal business be given by its lead brokers to its affiliates. It then credits the net income thus received by the affiliate, in whole or in part, against the advisory fee it receives from the fund. This results in lowering the advisory fee by all or part of the net income the manager has thus obtained. Through this means, public shareholders of institutions can, within the framework of existing practices developed by the securities industry, recoup substantial amounts of commissions actually paid for the execution of their portfolio orders despite a rigid commission structure which does not otherwise permit the institution to benefit from the very substantial portfolio business it may have to dispense. In one instance the advisory fees charged to a large complex of mutual funds by their common manager were lowered in the aggregate by approximately $3.1 million for the year 1966, this sum being the approximate net profit of the manager's broker-dealer affiliate. Other managers have elected to credit the advisory fees they charge by only 50 percent of the net profits of their broker-dealer affiliates. In a few instances, the mutual fund manager has kept all give-ups it has directed to its brokerage affiliate for itself without lowering the advisory fees it charges to the fund whose portfolio transactions are the source of such give-ups.

Although these techniques permit fiduciaries who manage a pooled fund to return a portion of portfolio commissions to the shareholders of that fund, they have to date been employed mainly by the managers of those mutual funds whose shares are sold by the manager's own "captive" sales force. Managers of those mutual funds which are distributed by independent broker-dealers have almost always used the excess brokerage to provide additional reward to dealers who sell shares of the fund rather than endeavoring to recapture such brokerage for the fund. This is because by so compensating dealers these mutual fund managers facilitate the sale of shares and thus maximize their own underwriting and investment advisory income. Many mutual fund managers believe that so long as this type of sales incentive can be given to dealers, competition among mutual fund managers for the favor of dealers will make it difficult, if not impossible, for any individual fund manager to fail to provide such compensation to dealers, both members and nonmembers of exchanges, selling shares of his funds. In this connection the Commission has been informed that certain large member firms of the New York Stock Exchange, who maintain extensive mutual fund departments and are a significant factor in the sale of mutual fund shares through dealers, have suggested to mutual fund managers that brokerage be channeled to them if they are to continue to sell shares of the manager's funds.

The net effect of the foregoing developments have been (1) a dramatic increase in the volume of transactions on regional exchanges, 2/ (2) a "diversion" of commissions which otherwise might have been retained by New York Stock Exchange members to

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2/ In 1961 the total dollar volume of transactions on regional exchanges was $4.4 billion; in 1966 it was $10.3 billion. This represented 6.8 percent of the dollar volume of transactions on all exchanges in 1961 and 8.4 percent of such volume in 1966. By comparison New York Stock Exchange dollar volume increased from $52.7 billion in 1961 to $98.6 billion in 1966; and New York Stock Exchange transactions declined from 82.6 percent of total dollar volume of exchange transactions in 1961 to 80.1 percent of such transactions in 1966. Dollar volume on the American Stock Exchange accounts for the balance. Substantially all of the regional exchange volume consists of trading in securities also traded on the New York Stock Exchange.

(a) other members who perform no function in connection with transactions and (b) non-members of the New York Stock Exchange who perform no function on transactions effected by New York Stock Exchange members on regional exchanges, and (3) a developing trend whereby excess commissions—the amounts which, at the direction of institutional managers, executing brokers are willing to give up to persons who perform no service or function in connection with the execution of portfolio transactions—are returned, at least partially, to the institutional customers thereby indirectly benefiting the millions of investors who invest through pooled media such as mutual funds. In short, competition in the securities industry between institutional managers and brokers and between exchanges, has operated to reduce very substantially the amount of commissions actually retained by executing brokers—but with relatively little impact or effect as yet on the commissions actually paid by the public investors who invest through institutional media.

In addition to practices with respect to commissions on institutional transactions, there are certain related competitive phenomena which deserve mention. As previously noted, the New York Stock Exchange rate structure expressly provides that nonmembers of that Exchange—including broker-dealers who are members of a regional exchange—must pay a New York Stock Exchange member a full commission for transactions executed on the New York Stock Exchange. Nevertheless, reciprocal business practices have developed which now give such regional exchange members indirect economic access to the floor of that Exchange.

For example, when a broker-dealer cannot execute its customer's order on the regional exchange of which it is a member, it has the order executed on the New York Stock Exchange, pays a New York Stock Exchange member a full New York Stock Exchange commission and collects that amount from the customer. Thus, the sole member of the regional exchange receives no direct compensation for its customer's order. However, it can receive indirect compensation equal to 50 percent of the commission paid by the customer. The member of the New York Stock Exchange through whom the order was executed brings its own customers' orders to the regional exchange, executes them there and names the sole member broker-dealer as the "clearing agent." Typically, under the rules of regional exchanges, the sole member may receive up to 50 percent of the stock exchange commission for acting as "clearing agent" on such orders, although he performs no function except the largely unnecessary one of guaranteeing performance by the New York Stock Exchange member.

Recent years have also seen a substantial growth in the so-called third market. This involves securities firms which are not members of any exchange and which deal in listed securities over-the-counter, both as principal and as agent, largely for institutional customers and broker-dealers not members of an exchange. Since exchange minimum commission rates do not apply to them, they have been able to execute orders either as principal or as agent for compensation substantially less than that provided for in the minimum commission rate rules. On the other hand, their ability to compete for institutional business has been adversely influenced by the fact that they are not in a position to provide give-ups for the benefit of institutional managers, since give-ups have generally been regarded as proper only where a minimum commission rate is applicable. Two incidents illustrate this point. One firm at one time specialized in executing institutional orders for listed securities in the over-the-counter market at a negotiated commission lower than that provided by exchange rules. Certain mutual fund managers suggested that it join a regional exchange and thus charge the higher commissions specified by the exchange and, at the same time, place itself in a position to distribute give-ups at the request of these managers and it did so in order to retain their business. Another large over-the-counter firm advised the Commission that instead of negotiating its compensation on each large institutional trade, it proposed unilaterally to establish a fixed non-negotiable commission but to give up a portion of this commission at the direction of mutual fund managers. This arrangement, which has not yet been put into effect, was motivated not because the firm thought that its existing negotiated compensation was inadequate but, rather, because it believed that its ability to provide give-ups would substantially improve its competitive position in seeking business from mutual fund managers even though its regular charges imposed on the funds were already lower than the New York Stock Exchange fixed minimum commission.

The Commission's jurisdiction under Section 19(b) of the Securities Exchange Act over Exchange rules with respect to "the fixing of reasonable rates of commission"

obviously extends both to the commission rate level and to the commission rate structure. Particularly in the earlier years the Commission's attention appeared to focus primarily on questions of level, although questions of structure also arose. The history of this consideration since 1937 is outlined in considerable detail in the Report of the Special Study of Securities Markets. 3/ As there pointed out, determination of a reasonable level of minimum rates for an industry as diverse, complex and, in a sense, competitive as the New York Stock Exchange brokerage community presents perplexing problems. In addition, questions of structure and questions of level are intimately related. Thus the Exchange proposal for a volume discount pertains to rate level as well as structure and is a response to the fact that the existing level of rates for large institutional transactions has, as a result of competitive factors, fostered the proliferation of give-ups and reciprocal practices.

These practices and problems, as outlined above, some of which are of relatively recent origin, have been the subject of intensive consideration by the Commission over a period of years. Reciprocal business practices and customer directed give-ups were described in the Report of the Special Study of Securities Markets. 4/ It was suggested that they be studied in connection with an intensive inquiry into all aspects of the commission rate structure. They were further discussed in the Commission's 1966 Report on the Public Policy Implications of Investment Company Growth. 5/ Approximately 19 months ago the Commission advised the exchanges of its belief that Exchange rules should be changed to preclude customer directed give-ups. 6/

Since consideration of the New York Stock Exchange proposal necessarily would involve an understanding and consideration of possible alternatives, the Commission believes that proposed Rule 10b-10 should now be noticed for comment. The Commission would thus be in the best position to consider all alternatives, including any which may be suggested.

THE EXCHANGE PROPOSAL

The first item of the New York Stock Exchange proposal involves the establishment of a volume discount. The Exchange has not yet determined the amount of such discount or the circumstances under which it would be available. There are a number of possible alternatives, including (1) a discount based upon the size of a particular order and (2) a discount based upon the volume of a particular investor's transactions over a specified period of time. The Commission assumes that the discount ultimately arrived at would be meaningful and workable. Upon that assumption it would appear that this part of the Exchange proposal would make an important contribution to resolving the problems discussed above and be in accord with suggestions that the Commission has made to the exchanges on several occasions.

Several other parts of the Exchange proposal appear to be based on the view that (1) the relatively untrammeled development of reciprocal and give-up practices, (2) the competitive advantages which regional exchanges have sought in competing for institutional business by increased liberality with respect to give-ups, and (3) the resulting "leakage" of commissions outside the New York Stock Exchange community, as threatening impairment of the depth and liquidity of the New York Stock Exchange market as well as the profitability and financial stability of member firms.

The Exchange proposal seeks to relieve this situation by (1) limiting to the

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3/ Special Study, Pt. 2, 328-346. H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

4/ Special Study, supra, 301, 318.

5/ Mutual Fund Report, Chapter 4, pp. 162-188.

6/ Mutual Fund Report, Chapter 4, pp. 185-186.

extent possible the major types of reciprocal business, (2) specifying the maximum percentages of the commission dollar which may be given away in any manner or, alternatively, specifying the minimum amount which must be retained, (3) preventing the regional exchanges from offering different and more liberal give-up arrangements so that institutional or other investors will not seek to execute or cross their transactions on regional exchanges in order to obtain more favorable give-ups, and (4) preventing what is some times referred to as "institutional membership" on exchanges, which appears to include membership of affiliates of an institutional investor whose function is to receive give-ups and reciprocal business and in whole or in part to pass the income therefrom back to the institutional investor itself. This is a significant part of the New York Stock Exchange proposal which would have a particularly important effect upon the securities markets, and would require action by the Commission. Consequently, comment with respect to it would be appreciated. These aspects of the Exchange's proposal may be viewed together as designed to make its minimum commission rates effective and enforceable insofar as large institutional transactions are concerned.

It would appear that the New York Stock Exchange proposal could have a substantial impact on the regional exchanges. A primary method by which regional exchanges have competed for the portfolio business of institutions has been to offer institutional managers a more flexible rate structure than that of the New York Stock Exchange, i.e., by permitting give-ups to a wider category of persons. Regional exchanges rely heavily on reciprocal business patterns which permit their sole members (nonmembers of the New York Stock Exchange) to obtain indirect access to the New York Stock Exchange. In this connection regional exchange rules facilitate reciprocal business practices by which dual members (members of the New York Stock Exchange and a regional exchange) compensate members of regional exchanges for business executed on the New York Stock Exchange. The New York Stock Exchange proposal would curtail such practices. It also would prevent institutions from obtaining membership on regional exchanges or otherwise engaging in reciprocal business practices which, in effect, reduce the portfolio commissions such institutions pay. Both the impact and the significance of the Exchange proposal, insofar as it involves the regional exchanges, are affected by a change which has taken place in the primary function of the regional exchanges. These exchanges were originally conceived of as primarily providing local markets for local securities. With the passage of time, the emphasis on most of the regional exchanges has shifted to providing a local market for securities traded on the New York Stock Exchange. Technical improvements in communication and the development of over-the-counter markets for local securities have contributed importantly to this change in the nature of the regional exchanges. As pointed out above, in many instances the participation of certain regional exchanges amounts to no more than providing a location where privately negotiated "cross" transactions in New York Stock Exchange listed stocks are recorded and give-ups are distributed.

Finally, the New York Stock Exchange proposal permits the continuation of customer directed give-ups and would expand them to provide for give-ups to nonmember broker-dealers of the New York Stock Exchange on executions on that Exchange. It would also provide for minimum retentions by executing brokers. The justification for these restrictions presumably is that competition in liberality with respect to customer directed give-ups is not a desirable form of competition and that the economic health of the exchange community calls for a sharp and enforceable distinction between public customers and the brokerage industry.

Certain aspects of the New York Stock Exchange proposal are not specific, i.e., the amount, kind, or applicability of the volume discount, the percentage of the minimum commission which a nonmember could receive and the qualifications which nonmembers would have to have in order to become eligible for this "access" and the amount of customer directed give-ups available to members and nonmembers, etc. Further, the Exchange proposal does not indicate whether the Exchange contemplates revision of the commission rate rules to relate commissions more directly to the money involved in a transaction rather than to the number of shares, thus modifying the existing disparity in commissions paid for a given investment in low priced stocks and in high priced stocks. This matter was discussed in a report to the exchange community from Mr. G. Keith Funston, then president of the Exchange, on July 21, 1967. Revisions along

this line, as suggested by Mr. Funston, would not only modify this disparity but might provide a convenient way of introducing the proposed volume discount.

The Exchange apparently is initially concerned with the principles and objectives underlying its proposal. In this connection, the Commission assumes that if these principles and objectives are accepted, the Exchange will determine the specifics, i.e., the dollar amounts, the percentages and the definitions, in such a way that the proposal will accomplish its intended purpose. Thus, for example, nonmembers would be offered a sufficient participation in commissions to induce them to bring their orders to the Exchange. The Commission understands that New York Stock Exchange members would be required to retain approximately 50 percent of the commission on any order with the balance available for customer directed give-ups.

The Commission believes that it is possible and appropriate for interested persons to express their views on the principles underlying the Exchange's proposal and the means by which its objectives may be accomplished even though, in the absence of more specific proposals, it may not be possible to determine the specific financial impact of various parts of the proposal on the earnings of various members and nonmembers or on the amount of commissions which institutional investors would pay.

PROPOSED COMMISSION RULE 10b-10

Proposed Rule 10b-10 represents an approach to the give-up problem which would not require significant change in the existing commission rate structure of exchanges nor require all exchanges to adopt a uniform approach to the question of give-ups and reciprocal business.

The Commission recognizes that the proposed rule is not a substitute for full reexamination of the structure and rates of commissions on the national securities exchanges. The proposed rule was under consideration prior to the announcement of the New York Stock Exchange proposal and has its antecedents in the Commission's Report on Investment Company Growth, which stated at p. 173:

> "It would not be inconsistent with [the] rules [of certain regional stock exchanges] for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the fund. 82/

> "82/ Alternatively, the fund itself could form a broker-dealer affiliate to which it could direct give-ups. If this course were followed—and no fund now does so—the give-ups would inure to the direct benefit of the fund's shareholders."

The reasoning on which the proposed rule is based is that if, as pointed out above, a mutual fund manager has various means at his disposal to recapture for the benefit of the fund a portion of the commissions paid by the fund, he is under a fiduciary duty to do so. Furthermore, diversion of such commissions to benefit an investment company manager may be viewed as additional compensation to the manager for handling the portfolio transactions of the fund within the meaning of, and in violation of, Section 17(e)(1) of the Investment Company Act. 7/

The proposed rule therefore reflects a duty on the part of mutual fund managers as fiduciaries not to use commissions paid by their beneficiaries for the benefit of the

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7/ The Commission does not believe that investment company directors may properly view the benefits derived by fund managers from give-ups as simply an additional form of compensation for investment management. Not only may this run afoul of Section 17(e)(1) of the Investment Company Act but the benefits derived by investment company managers from this source cannot be precisely or adequately disclosed in the prospectus, or in the investment advisory contract, as is required by Section 15(a)(1) of the Investment Company Act.

fiduciary when practices, procedures, and rules of the markets in which such fiduciaries act permit their beneficiaries to receive tangible benefits in the form of reduction of the charges now borne by them. The proposed rule is bottomed on the premise that when a fiduciary uses commissions to obtain benefits for himself under these circumstances, his conduct would appear to violate applicable antifraud provisions of the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 as well as Section 17(e) of the Investment Company Act, particularly in view of the obscure and often devious ways in which this is accomplished. The proposed rule would be adopted pursuant to Sections 10(b) and 15(c)(1) and (2) of the Securities Exchange Act of 1934, Sections 206(4) and 211(a) of the Investment Advisers Act of 1940 and Sections 17(e) and 38(a) of the Investment Company Act.

The proposed rule would not impair the competition which now exists among brokers and among exchanges for the business of institutional customers by offering these customers substantial savings on commissions. On the contrary, the proposed rule recognizes that, as mentioned above, developments and competitive forces in the securities markets have, as an economic matter, tended to eliminate the existence of a fixed minimum commission rate on institutional orders.

The proposed rule would read as follows:

"Rule 10b-10

"(1) It shall be unlawful for any registered investment company or affiliated person of such registered investment company* to directly or indirectly, to order or request any broker or dealer:

"(a) to pay or arrange for the payment, directly or indirectly, of all or any portion of a commission on any securities transaction to any broker, dealer or any other person unless pursuant to a written contract the full amount of such remittance is required to be paid over to such registered investment company, or fees owed by or charged to such registered investment company are required to be reduced in an amount equal to the remittance;

"(b) to designate or employ any broker or dealer on any transaction to transmit, execute or clear a transaction or to perform any other function for which compensation is required or made unless pursuant to a written contract the full amount of such compensation is required to be paid over to such registered investment company or fees owed by or charged to such registered investment company are required to be reduced in an amount equal to such compensation.

"(2) For the purposes of this rule a person is affiliated with a registered investment company if such person:

"(a) is an officer, director, trustee, employee, investment

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* Although the proposed rule is couched only in terms of persons who are affiliates of and fiduciaries to investment companies, the principles which are set forth above may be equally applicable to other managers of pooled funds who act in a fiduciary capacity and who are able to reduce the portfolio commissions of their beneficiaries. To the extent that such managers direct give-ups for their benefit, when they are in a position to utilize them for the benefit of beneficiaries, it would appear that under the Federal Securities Laws or otherwise, this use of give-ups other than for the benefit of these beneficiaries would also constitute an improper practice by such fiduciaries. Accordingly, the Commission believes that it is appropriate to solicit comment on this issue and will consider whether the proposed Rule 10b-10 should be applicable to other fiduciaries who manage pooled funds.

adviser, member of an advisory board, depositor, promoter of or principal underwriter for the registered investment company, or

"(b) directly or indirectly, through one or more intermediaries, controls, or is controlled by, or is under common control with the registered investment company, its investment adviser or principal underwriter, or

"(c) directly or indirectly owns, controls, or holds with the power to vote, five per centum or more of the outstanding voting securities of the registered company."

While the New York Stock Exchange proposal and proposed Rule 10b-10 are not mutually exclusive on all points, the New York Stock Exchange proposal is, to a significant extent, an alternative approach. Insofar as the New York Stock Exchange proposal would provide institutional investors with a volume discount while at the same time closing, insofar as possible, the various avenues by which an institutional manager can recoup commissions for the benefit of the fund, it could, depending upon the nature and extent of the volume discount, provide a direct rather than an indirect means by which institutional investors may obtain the benefit of lower charges. To the extent that it would make impossible indirect recoupment of commissions by institutional managers, the question of a fiduciary duty on their part to seek such recoupment would not arise.

All interested persons are invited to submit their views and comments on proposed Rule 10b-10 in writing to the Secretary, Securities and Exchange Commission, at its principal office, 500 North Capitol Street, Washington, D.C. 20549, on or before March 1, 1968. The Commission also invites comments on the New York Stock Exchange proposal which is set forth in the attachment of this release, as well as any alternative suggestions for dealing with the problems presented. Material submitted will be made available for public inspection unless request for confidential treatment is made.

By the Commission.

Orval L. DuBois
Secretary

Attachment

NEW YORK STOCK EXCHANGE
ELEVEN WALL STREET
NEW YORK, N.Y. 10005

ROBERT W. HAACK
PRESIDENT

January 2, 1968

TO: Members and Allied Members

SUBJECT: Commission Rate Structure Proposal

A principal unsolved problem facing the securities industry is that involving the New York Stock Exchange commission rate structure. The complexities and ramifications are such that they are not generally understood even though they directly or indirectly affect the New York Stock Exchange and its members, regional exchanges and their members, the third market, non-member broker-dealers, institutional investors and, of course, the public.

The problem has become more acute by reason of certain pressures which are building up in Congress, government agencies and departments, a segment of the press and the SEC which has oversight responsibilities in the area. The issue is further complicated by the fact that the Exchange, enjoying the privilege of self-regulation and operating under a government approved commission rate structure and certain anti-trust immunities, has an obligation to review its fees and industry developments and practices in the light of public interest. This is a problem which cannot be solved by the Exchange alone. However, inaction on our part is apt to result in the problem being solved by those outside the industry who may be less familiar with the ramifications and as a result might direct changes less satisfactory than those we initiate.

The minimum commission rate is ceasing to be a "minimum" because of practices which have developed and which are proliferating. This is the case in large measure because certain institutional investors are naturally desirous of achieving a lower commission rate on large transactions, and brokers who are non-members of this Exchange are understandably interested in achieving access to the commission dollar. To accomplish these objectives, among others, a wide range of devices is being employed. Membership on regional stock exchanges, used in both simple and complex reciprocal arrangements related to NYSE transactions, has resulted in a practical access to the New York Stock Exchange. Other practices have in effect given certain institutions commission discounts. One exchange, by permitting rebates to SECO members, in effect is giving a public and institutional discount. Through complicated arrangements there are now certain sophisticated individuals who manage to receive 40% rebates on their listed transactions. The net result,

in brief, is an intricate maze involving give-ups, give-aways, reciprocal practices, manufactured participations in trades, transported trades moved from one Exchange to another, all of which result in a leakage of the commission dollar.

The situation also reflects a commission structure which was most recently revised in 1959 and which does not properly recognize significant changes which have since taken place in the mix of our business. We are all aware of the increased institutional activity which is one of the significant phenomena of our time and which in all likelihood will continue to grow. It seems reasonable that institutional business with its unique characteristics and demands must be recognized in our commission charges. Moreover, failure to recognize and speak to the problem will inevitably result in a diversion of activity to competing marketplaces.

Because of all of the foregoing, the Board of Governors has unanimously adopted a resolution which had earlier been recommended by the Cost and Revenue Committee and which has the further approval of the Regional Firms Advisory Committee and the Liaison Committee of the Association of Stock Exchange Firms to the effect that the New York Stock Exchange proposes to

(1) incorporate a volume discount in the minimum commission schedule, the amount and nature of such discount to be subsequently determined.

(2) support continuation of the practice of customer directed give-ups on their own transactions with a limitation on the percentage amount which may be so given-up.

(3) take steps to prohibit reciprocal practices which result in de facto rebates of NYSE commissions even where those arrangements involve other markets than the NYSE floor, provided that the SEC will aid in prohibiting such practices in other markets.

(4) allow a discount in the minimum commission schedule for non-member brokers, both domestic and foreign, with qualifications to be specifically defined subsequently.

(5) at the order of the SEC to this and other registered exchanges, adopt rules limiting membership and broker-dealer allowances to bona fide broker-dealers.

Because of the interrelationship of these proposals these courses of action are offered as a package. Further, the specific details of each of the five elements of the package will have to be developed subsequently.

The first proposal described would give directly to large investors, principally institutions, and to the public which has entrusted its funds to institutions, a commission reduction to which they are entitled by size of transaction and which some are presently receiving circuitously.

Continuance of customer directed give-ups on a reduced and controlled basis would tend to eliminate abuse in granting of reciprocals, and would give recognition to the fact that there is more to an order than its execution.

The third proposal, involving an enforcement of rebate rules, would help to eliminate undesirable reciprocal practices and arrangements engaged in by some which through certain other exchanges and the over-the-counter market, result in NYSE commission "leakage".

Because we recognize and respect the desire of non-NYSE brokers to merchandise securities listed on our Exchange profitably, and preferring not to have them compensated by artifice, we propose that certain qualified brokers be given an opportunity to share the commission dollar directly instead of indirectly. The public will be better served and depth and liquidity of markets on our Floor will be improved.

Our last proposal restricting future membership in any exchange to bona fide broker-dealers is necessary to insure the health and vitality of our securities distribution and auction market mechanisms as we know them.

Chairman Gustave Levy and I presented these proposals for consideration by the SEC this morning. I cannot emphasize too strongly the important role that the SEC must play in considering and evaluating the action which has been taken by the Board of Governors.

Subject to Commission reaction, the Cost and Revenue Committee intends to proceed immediately with drafting rules and commission structure to accomplish these ends.

Robert W. Haack,
President

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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ROSALIND FOGEL and GERALD FOGEL, :

Plaintiffs, :

-against- :

GEORGE A. CHESTNUTT, JR., et al., :

Defendants. :

- x

68 Civ. 2855 (IBW)

RESPONSES TO PLAINTIFFS' INTERROGATORIES - SECOND SERIES

Defendants CHESTNUTT, et al., furnish the following responses to Plaintiffs' Interrogatories, Second Series.

[NOTE: There is no Interrogatory numbered "3" or numbered "8", this Series having plainly been tailored from a pattern applicable to a "load" fund having an "underwriter", rather than the facts applicable to American Investors Fund, Inc., a "no-load" fund having no "underwriter" or "dealer-distributor".]

Interrogatory No. 1:

1. For each of the years 1963 through 1971 list the total dollar volume of commissions paid by American Investors Fund, Inc. (the "Fund") on portfolio transactions executed otherwise than on a national securities exchange.

Response to Interrogatory No. 1:

This Interrogatory has already been

Response to Interrogatory No. 4 of Plaintiffs' First Series of Interrogatories where, by stipulation of the parties, the answer was derived from the business records of defendants to show data for the stipulated year 1968 with respect to all transactions executed other than on a national securities exchange. The burden of deriving or ascertaining information and answers with respect to other years is substantially the same for the plaintiffs serving this interrogatory as for the defendants, and notwithstanding the stipulation, if plaintiffs now desire information with respect to additional years, plaintiffs are hereby afforded reasonable opportunity to examine, audit and inspect defendants' records and make copies, compilations, abstracts and summaries of such records which are the records of portfolio transactions kept in accordance with requirements of the Securities and Exchange Commission.

Interrogatory No. 2:

2. (a) State whether any of the defendants, their officers, agents or employees have at any time from January 1, 1963 to the present directed brokerage business of the Fund to a New York Stock Exchange member or member organization in return for the executions by such New York Stock Exchange member or member organization of unrelated transactions on a regional securities exchange (i.e., a national securities exchange other than the New York Stock Exchange or American Stock

(b) If the answer to (a) above is in the affirmative, state for each of the years 1963 through 1971:

1. The total amount of commissions on such unrelated trades executed on regional exchanges;

2. The total amount of give-ups paid on such unrelated trades;

3. The purpose for utilizing such unrelated trades;

4. The total amount of give-ups on such unrelated trades paid to non-members of a national securities exchange;

5. The person or persons making such request or direction.

Response to Interrogatory No. 2:

No.

Interrogatory No. 3:

[There is no interrogatory numbered "3"]

Interrogatory No. 4:

4. (a) For the years 1963 through 1971 state whether any methods were ever utilized or attempted to be utilized to channel amounts paid as commissions on Fund portfolio transactions executed on the New York or American Stock Exchanges to non-members of said Exchanges.

(b) If the answer to (a) above is affirmative, describe each such method used or attempted, identifying in each case the persons or firms involved, the dollar amounts of commissions involved, the duration of the practice, and the reasons for its use and termination.

Response to Interrogatory No. 4:

No.

Interrogatories Nos. 5, 6, 7:

[NOTE: Interrogatories 5, 6 and 7 are answered together

5. (a) State whether at any time from January 1, 1963 to the present any of the defendants discussed with or otherwise informed any unaffiliated directors of the Fund of the possibility of recapturing the Fund's brokerage commissions in any manner whatsoever, including but not limited to membership on regional exchanges, or N.A.S.D. affiliation by Chestnutt Corp. (the "investment adviser").

(b) If the answer to (a) above is in the affirmative, identify and describe each such discussion and all memoranda, minutes and other writings referring to such discussions.

6. State whether at any time from January 1963 to the present any discussion of the possibility of Exchange membership for the Fund, the investment adviser or any affiliate of the Fund or the investment adviser was discussed between or among any directors of the Fund, or th

investment adviser, and if so identify and describe each such discussion, including the time, place and persons present, and all memoranda, minutes or other records referring to such discussions.

7. (a) Identify and describe, by time, place and persons present, all meetings of the boards of directors of the Fund or the investment adviser from 1963 to the present at which the possibility of recapturing brokerage commissions was discussed.

(b) State whether there is any existing record of such discussions, including but not limited to memoranda, minutes, correspondence or tape recordings.

Response to Interrogatories Nos. 5, 6, 7:

All directors of the Fund knew and have always known since becoming directors that the Fund was a "no-load" Fund and sells its shares directly by mail, and to some extent upon receipt of telephone orders, to subscribers who become Fund shareholders by such direct purchases without the intervention of, or any commission payable to, any broker or dealer, or underwriter. Accordingly, the Fund differs from most other mutual funds in that it is not "dealer-distributed", nor is there any "underwriter", nor is there any broker or dealer affiliated with the Fund or affiliated with the Adviser or affiliated with any officer or director of either, and all directors of the Fund have known these

facts at all times.

No director has suggested that the Adviser divert its resources, efforts and talent from advice and management of investments to enter the new, untried and risky business of public brokerage or underwriting as one of many prerequisites to becoming a member of an exchange or of the N.A.S.D. The management of the Adviser understands that unaffiliated directors of the Fund are and have been categorically opposed to any brokerage or underwriting activity by the Adviser or such activity by any new brokerage or underwriting entity which might be created by or at the instance of the Adviser, because of the inherent conflict of interest and the diversion of attention and resources from investment advice and management.

All Fund directors have had brought to their attention the February 1972 statement by the Securities and Exchange Commission relating to the future structure of securities markets, including the separate statement by its senior member, Commissioner Owens, expressly disapproving any brokerage functioning whatever by an affiliate of a mutual fund on its behalf, as constituting a clear conflict of interest, as well as the majority text suggesting the propriety of stock exchange membership and brokerage functioning where the brokerage activity was preponderantly for the public, together with informal Commission statements indicating that any brokerage whatever for an affiliated mutual fund should be permitted only where 80% of the brokerage business

was with the general public as distinguished from any affiliated mutual fund. The Adviser, upon advice of counsel, and in view of widely varying contentions advanced in legislative committees, conflicting views within the Securities and Exchange Commission, and widely varying views within the securities industry with respect to market structure, commission rate structure, applicability of antitrust laws, access to markets, and a variety of other matters, has in 1972 caused incorporation papers to be drawn for a possible brokerage subsidiary of the Adviser, which incorporation papers have not been filed pending clarification of legislative and practical considerations in the future, and the unaffiliated directors have been so informed.

A/ Subsequent to the filing of an action by these identical plaintiffs in this Court, against these defendants and others in January 1967, (67 Civ. 60) which claimed, among other things, impropriety in connection with brokerage commissions charged on Fund portfolio transactions Messrs. Cahill & Lee counsel has advised all of the directors of the Fund and the Adviser on numerous occasions, including meetings of such Boards, that no impropriety had been found in connection therewith. On or about February 1968, upon the issuance by the Securities and Exchange Commission of its 1934 Act Release No. 8239 dated January 26, 1968 proposing a new Rule 10b-10 (which proposal the Commission later withdrew), Messrs. Cahill & Lee ~~counsel~~ specifically advised all of the directors of the Fund and the Adviser that the suggested form of "recapture"

proposed, but never adopted, new Rule 10b-10 by its express terms applied only to "dealer-distributed funds", rather than a no-load fund such as the Fund which has no "distributor" or "underwriter", and counsel advised that the question of possibility of recapture of brokerage commissions which the Fund is compelled to pay upon execution of portfolio transactions does not arise.

Defendants do not believe that there are any papers or writings referring to any such discussions but defendants are continuing to search for any. Such advice from counsel has been on a continuing basis, including conferences with defendants in connection with the defense of both actions brought by these plaintiffs and in connection with periodic review of the Fund's Prospectus.

Interrogatory No. 8:

[There is no interrogatory numbered "8"]

Interrogatory No. 9:

9. (a) State whether from January 1, 1963 through December 31, 1971, any of the defendants, their officers, agents or employees testified before or participated in a transcribed discussion with the United States Securities and Exchange Commission or its Staff, any state securities commission or any securities self-regulatory agency with respect to the payment of brokerage commissions, the execution of securities transactions, the payment of investment advisory

fees, the performance of investment advisory services, or the performance of underwriting or distribution services.

(b) If the answer to (a) above is affirmative, state the following:

1. The person or persons testifyin or participating in each such discussion;

2. For each such person, the date of his testimony or discussion;

3. In each case, the agency conducting the hearing or discussion;

4. In each case, the nature of the subject matter testified to or discussed;

5. In each case, whether the defendants have in their custody, possession or control a copy of the transcript of such testimony or discussion; and

6. If the defendants do not have in their custody, possession or control a copy of such testimony or discussion, who does have such a copy.

Response to Interrogatory No. 9:

No, except to the extent that the transcript heretofore furnished plaintiffs' counsel of testimony in 1965 and 1966, etc. may touch upon any of such matters.

Interrogatory No. 10:

10. State separately with respect to the meetings and proceedings of the Fund's and the investment adviser's (1) stockholders, (2) boards of directors, and (3) directors' committees, what records thereof were kept, including without limitation: minutes, transcripts, phonetic records, correspondence, memoranda, informal notes and notice of meetings and agenda.

Response to Interrogatory No. 10:

Records of each separately are minutes and where applicable notices and proxy statements and agenda.

Interrogatory No. 11:

11. (a) State whether the allocation of the Fund's portfolio brokerage business among broker-dealers was ever the topic of discussion at the Fund's or the investment adviser's boards of directors meetings during the period January 1, 1963 to date.

(b) If the answer to (a) above is in the affirmative, identify and describe all such discussions by stating the dates, times, persons present and subject mat of all such discussions.

(c) If any record exists of such discussions, identify and describe such record and state in whose custody such record is being held.

Response to Interrogatory No. 11:

No, except that the Fund's policies with respect to brokerage are set forth in prospectuses which were reviewed and approved by the directors of the Fund as recorded in minutes of such meetings in the custody of corporate defendants.

ROGERS HOGE & HILLS

By Clendon H. Lee
Clendon H. Lee
Counsel for
GEORGE A. CHESTNUTT, JR.
JOHN CURRIER
WARREN K. GREENE
STANLEY L. SABEL
AMERICAN INVESTORS CORPORATION
CHESTNUTT CORPORATION

STATE OF NEW YORK)
COUNTY OF NEW YORK) ss.

CLENDON H. LEE, being duly sworn, deposes and says that he has read the foregoing Responses to Interrogatories - Second Series and knows the contents thereof and upon information and belief the same are true. The source of deponent's information is general familiarity with this case and conversations with defendants and examination of files as well as personal knowledge as counsel, and this verification is made by deponent because defendants are without the County wherein deponent has his office.

Clendon H. Lee
Clendon H. Lee

Sworn to before me this
5th day of January, 1973.

Helen L. Kriegel
HELEN L. KRIEGEL
NOTARY PUBLIC, State of New York
No. 31-7963575
Qualified in New York County
Commission Expires March 30, 1974

LOOMIS-SAYLES MUTUAL FUND
INCORPORATED

276a

P.O. BOX 449, BACK BAY ANNEX, BOSTON, MASSACHUSETTS 02117
(617) 267-6600

Prospectus

APRIL 30, 1973

Loomis-Sayles Mutual Fund, Incorporated (the "Fund") is a flexibly managed mutual fund which seeks reasonable long-term capital appreciation with a prudent approach to protection of capital from undue risks. Consideration is given to current income in the selection of portfolio securities but it is not a controlling factor. The proportion of common stocks, preferred stocks and bonds in the Fund's diversified portfolio is varied from time to time according to management's appraisal of the economic and investment outlook.

Loomis, Sayles & Company, Incorporated ("Loomis Sayles"), one of the largest and oldest investment counsel firms in the country, serves as investment adviser to the Fund under an advisory contract providing for a fee at the annual rate of ½ of 1% on the first $100 million of the Fund's average net assets and ⅜ of 1% on average net assets above this amount, as described under "Investment Adviser and Distributor".

Shares of the Fund are offered to the public at the current net asset value which varies with fluctuation in the market value of the Fund's portfolio. **NO SALES CHARGE IS INCLUDED IN THE PRICE OF THE SHARES.** The initial investment to open an account must be at least $250 and any subsequent investment must be at least $50.

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THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

The investor is advised to retain this prospectus for future reference.

December 31, 1972 the Fund paid total brokerage fees of approximately $300,000. About 30% of this total was allocated to brokers and dealers on the basis of such supplementary information and market quotations. In 1970 and 1971 the Fund paid total brokerage fees of approximately $265,000 and $445,000, respectively. None of this brokerage was placed with brokers on the basis of sales of Fund shares.

L. S. Corporation, a wholly owned subsidiary of Loomis Sayles, is a preferred rate nonmember of the Boston and Pacific Coast Stock Exchanges for the purpose of recapturing brokerage for the Fund and other registered investment companies advised by Loomis Sayles. In this capacity, L. S. Corporation receives from time to time a portion of the brokerage commissions on Fund portfolio transactions carried out on these exchanges. When L. S. Corporation receives brokerage commissions on Fund portfolio transactions in this manner, the compensation to be paid by the Fund to Loomis Sayles under the investment advisory contract is reduced by an amount equal to such commissions, less expenses of L. S. Corporation properly attributable thereto. Similar brokerage recapture arrangements were effectuated by NELESCO with respect to portfolio transactions of the Fund for the years 1971 and 1972, and such arrangements resulted in a reduction in the compensation paid to Loomis Sayles by the Fund under the advisory contract in the amount of $2,945 in 1972.

OWNERSHIP OF SHARES

The Fund has authorized capital of 20,000,000 shares of common stock, $1 par value. The Fund's shares of common stock, when issued, are fully paid and nonassessable and have no preemptive or conversion rights. The shares are freely transferable, are entitled to dividends as determined by the Board of Directors and in liquidation are entitled to a ratable distribution of the net assets of the Fund. Shareholders are entitled to one vote per share on all matters subject to shareholder action.

At March 3, 1973 there were 11,221,779 capital shares of the Fund issued and outstanding, excluding treasury shares.

LITIGATION

In December, 1968, an action entitled *Joseph B. Kauffman* v. *The Dreyfus Fund, Inc. et al.*, was brought in the United States District Court for the District of New Jersey against sixty-five named mutual funds, mutual funds "affiliated or related thereto", the investment advisers of the named funds and certain affiliated individuals. The plaintiff purports to bring the action derivatively on behalf of four funds in which he allegedly owned shares. The plaintiff is not a shareholder of the Fund, but the Fund and Loomis Sayles are named in the complaint. The action, as brought against the Fund and Loomis Sayles, was transferred to the United States District Court for the District of Massachusetts, where it was dismissed without prejudice on July 7, 1972 on certain preliminary motions by the defendants. The dismissal has been appealed to the United States First Circuit Court of Appeals. The complaint alleges a conspiracy among managements of externally managed mutual funds and others to fix excessive management fees and to restrain competition. The complaint seeks damages in an unspecified amount and injunctive relief. The Fund denies, and is informed that Loomis Sayles and other funds advised by it also deny, any wrongdoing alleged against them in the complaint.

SCUDDER, STEVENS & CLARK COMMON STOCK FUND, INC.

(A NO LOAD FUND ORGANIZED IN MASSACHUSETTS IN 1929 BY SCUDDER, STEVENS & CLARK)

10 Post Office Square, Boston, Massachusetts 02109
Area Code 617—482-3990

PROSPECTUS

APRIL 30, 1973

A No Load Fund. This is a no load fund wherein the investor buys shares at the net asset value without payment of a sales charge.

Subscription Requirements. Investors must subscribe initially for at least $500 in Fund shares except under certain plans. Subsequent purchases by check may be for any amount; the minimum is $500 if orders are received unaccompanied by check. See "How to Buy Shares," page 5.

Investment Objectives. The Fund is designed to provide investors with a portfolio of common stocks. Its objective is possible long-term growth of capital. The above objective cannot be changed without the affirmative vote of (1) the holders of a majority of the outstanding shares of Capital Stock of the Fund or (2) the holders of 67% of the shares present if more than 50% of the shares are present at a meeting in person or by proxy, whichever is less.

This Prospectus contains information you need to know about this investment company. It is important that you read it carefully BEFORE you decide to invest and retain it for future reference.

Investment Adviser. The Fund's investments are supervised by Scudder, Stevens & Clark, one of the nation's oldest and largest firms of investment counsel. The Fund has an investment advisory contract with Scudder, Stevens & Clark under which it pays a quarterly fee of 1/8 of 1% (approximately 1/2 of 1% on an annual basis) of the average daily net assets of the Fund, except that for any calendar quarter during which the average of the daily values of the Fund's net assets exceeds $125,000,000, the fee payable for that quarter based on the portion of the average net asset value over $125,000,000 shall be 1/10 of 1% (approximately 2/5 of 1% annually) of that portion. See "Investment Advice," page 9.

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

ALLOCATION OF BROKERAGE: With respect to the purchases and sales of securities for the portfolio of the Fund, the primary objective is to obtain the most favorable prices and execution of orders. It is the Fund's practice, when it can be done, consistent with the policy of obtaining best price and execution, to place a portion of orders for the purchase and sale of portfolio securities with brokers and dealers who supply market quotations to the custodian of the Fund for appraisal purposes, or who supply supplementary research and statistical information to Scudder, Stevens & Clark, the Fund's investment adviser.

In the fiscal year ended December 31, 1972, $208,604 (55.3%) of the total brokerage commissions ($379,063) paid by the Fund resulted from orders placed, consistent with the policy of obtaining best price and execution, with dealers on the basis of providing research information to the investment adviser. The Fund also paid brokerage commissions of $2,037 (0.5%) for transactions placed with dealers who supply market quotations to the custodian of the Fund for appraisal purposes. Although research, market and statistical information from brokers and dealers is useful to the Fund and to its investment adviser, it is the opinion of the Management of the Fund that such information is only supplementary to the investment adviser's own research effort since the information must still be analyzed, weighed, and reviewed by the adviser's staff. An additional portion of such brokerage business was placed with brokers and dealers using the sales of shares of the Fund resulting from their recommendations as a factor in the selection of such brokers and dealers. In the year ended December 31, 1972, $1,055 of the Fund's brokerage business was so placed. On March 7, 1972, the Board of Directors of the Fund voted to discontinue this policy. The balance of such brokerage was not allocated to any particular dealer or with regard to the above-mentioned or any other special factors. Except for implementing the policy above stated, there is no intention to place portfolio transactions with any particular brokers or dealers or group thereof. In effecting transactions in over-the-counter securities, the Fund deals with the principal market-makers for the security being traded unless, after exercising care, it appears that better price and execution are available elsewhere.

The Fund generally uses the personnel and facilities of Scudder Fund Distributors, Inc., a corporation wholly-owned by Scudder, Stevens & Clark, to place orders on behalf of the Fund with other brokers and dealers. Scudder Fund Distributors, Inc. receives no commission, fees or other remuneration from the Fund for this service. The requirement that members of national securities exchanges charge a fixed minimum commission on transactions in listed securities has been eliminated for that portion of any order greater than $300,000. In such transactions, the Fund may combine its purchase or sales orders with other investment company clients advised by Scudder, Stevens & Clark in order to take advantage of negotiated commissions on the portion of the combined order in excess of $300,000 and quantity discounts applicable to orders in excess of $2,500 or 1,000 shares but less than $300,000. In placing such orders, the Fund will continue to seek the best price and execution, taking into consideration the rate of commission on such excess. The Securities and Exchange Commission has proposed that the amount beyond which commissions are subject to negotiation be reduced to $100,000. If the proposal of the Commission is implemented, the Fund will conduct its portfolio transactions in accordance with the announced policy.

In order to take advantage of opportunities for recapture of brokerage commissions for the benefit of the Fund, as of December 1, 1971, Scudder Fund Distributors, Inc. became an approved non-member of the Pacific Coast Stock Exchange and on December 22, 1971, it became an approved non-member of the Boston Stock Exchange. As a member of the National Association of Securities Dealers, Inc., Scudder Fund

Distributors may receive a discount from the specified minimum commission on transactions executed on the Detroit Stock Exchange. If Scudder Fund Distributors effects any portfolio transactions for the Fund on these exchanges, it is intended to credit any net savings in commissions against the advisory fee payable to the adviser. During the fiscal year ended December 31, 1972 $6,990 was credited in commissions against the advisory fee payable to Scudder, Stevens & Clark. No transactions will be placed upon any exchange unless it is believed that best price and execution can be achieved. It is possible that generally similar arrangements at the same or different rates may be permitted by other regional stock exchanges. There is no assurance that any such arrangements on the Boston, Detroit, Pacific or other stock exchanges will continue or will result in significant savings to the Fund. On January 16, 1973, the Securities and Exchange Commission stated that it is reviewing the ability of institutional members, such as the Fund, to continue to obtain a credit for a portion of its brokerage commissions on all or some of these exchanges.

HOW NET ASSET VALUE IS DETERMINED: The net asset value is determined by the Custodian, State Street Bank and Trust Company, as of the close of trading on the New York Stock Exchange on each day, during which such Exchange is open for trading, by dividing the total assets of the Fund, less all liabilities, by the total number of shares outstanding. Such determination is made (a) by appraising portfolio securities which are traded on the New York Stock Exchange at the last sale price on that Exchange on the day as of which assets are valued, or, if no sale occurs, the security is valued at the closing bid price, except that where the spread between bid and asked is more than two points, the mean price between such bid and asked is used and except that if no bid price is available, then a price one-half point less than the offering price, if available, is used, (b) by appraising other securities as nearly as possible in the manner described in clause (a) if traded on any other exchange, or actively traded in the over-the-counter market, and (c) by appraising all other securities, including restricted securities and securities for which no market quotation is available and other assets, at fair value as determined in good faith by the Board of Directors.

The Fund may issue shares at net asset value in connection with any merger or consolidation with, or acquisition of the assets of, any investment company or personal holding company, subject to the requirements of the Investment Company Act of 1940.

UNDERWRITING CONTRACT: The Fund has an underwriting agreement with Scudder Fund Distributors, Inc., a Massachusetts corporation formed in 1947. The Fund's underwriting contract has been continued until May 1, 1974 and remains in force from year to year thereafter only if its continuance is approved annually by a majority of the members of the Board of Directors who are not parties to such contract or interested persons of any such party and by vote of a majority of the Board of Directors or a majority of the outstanding shares. The Fund has agreed to pay all expenses in connection with registration of its shares with the Securities and Exchange Commission and filing fees in connection with registration of its shares under the various state "blue-sky" laws and assumes the cost of preparation of prospectuses, stock certificates and other expenses. Scudder Fund Distributors, Inc. pays all expenses of printing prospectuses used in offering shares, expenses other than filing fees of qualification of Fund shares in various states and all other expenses in connection with the offer and sale of shares which are not specifically allocated to the Fund. Scudder Fund Distributors, Inc. also acts as underwriter for Scudder, Stevens & Clark Balanced Fund, Inc., Scudder Special Fund, Inc., Scudder Development Fund, Scudder International Investments Ltd., and Farm Bureau Mutual Fund, Inc. The expenses of its operations are borne by Scudder, Stevens & Clark by whom it is wholly owned.

[SUBCOMMITTEE PRINT]

SECURITIES INDUSTRY STUDY

REPORT

OF THE

SUBCOMMITTEE ON COMMERCE AND FINANCE

OF THE

COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE HOUSE OF REPRESENTATIVES

ent timetable, and stated that it will review the level for competitively determined commission rates in October 1972. The Subcommittee has heard testimony that the difference in impact on the industry between a $500,000 breakpoint and a $300,000 breakpoint is minimal, and a number of witnesses indicated that a further reduction in the breakpoint may be warranted prior to the date scheduled by the SEC. The Subcommittee agrees. A further reduction in the breakpoint by the Exchange when it conducts its review in October is warranted. The SEC could then adjust its timetable accordingly. So long as reasonable progress along this road is being made, the Subcommittee will defer legislative action.

The Subcommittee agrees with the testimony of a large number of witnesses that there is no reason to freeze competitive rates at the $100,000 level. The Subcommittee finds no logical justification for competition on institutional size transactions while perpetuating rate fixing on transactions of small investors. If steps are not taken to continue to reduce the breakpoint below the $100,000 level until all fixed rates are abolished, the Subcommittee will introduce legislation to do so.

There has been much debate over the desirability of a fixed minimum commission rate system. But the Congress, the Department of Justice, and the SEC have determined that the public interest will best be served by replacing fixed prices with a competitive rate system. The debate should now end. If the securities industry expends as much energy in adjusting to a competitive system as it has in debating its wisdom, the Subcommittee is convinced that the industry will not only survive, but it will flourish.

10. Qualifications for membership on registered national securities exchanges

The controversy over institutional membership has been intense, the statements pro and con have been full, the resolution whatever it may be will have pervasive and far-reaching impacts, and thus the question is doubtless as important as any other now before us.

It is clear from our hearings, as well as from material presented before our Senate counterparts and the Commission, that the case for preserving a flat bar against institutional membership—a bar which even the New York Stock Exchange itself is now proposing to lift—has not been made. First, such a bar against entry of strong competition is unique and inconsistent with our national preference for competition rather than monopoly, oligopoly, or regulation. Second, even where such a bar has been imposed, it has been applied inequitably, in that broker-dealers inside the bar have been allowed to enter into competition with outsiders in such lucrative fields as money management, insurance sales, and so forth, but outside firms whose prime activity is in those fields have not been allowed to compete in the broker-dealers' field. As a result, firms outside have suffered demonstrable competitive disadvantages. Moreover, the exchanges imposing the bar against institutional membership have not even been consistent in excluding all outsiders, as evidenced by the member firms which are substantially or wholly owned by a foreign bank, a tire company, a conglomerate which includes an insurance company, and so forth.

The Commission and even those exchanges where the ban against

institutions has been most strongly defended are now proposing its replacement. Our overriding concerns are: (1) To assure that the replacement does indeed remove the competitive inequities and other negative impacts of the flat ban. It must not be a minimal move calculated to deflate the controversy just enough to allow preservation of near-monopoly privileges. (2) To assure that in the manifold changes now occurring, the markets do not become the exclusive province of institutional investors, but retain broad public participation. Every witness who testified on this matter, whether representing the Commission, any segment of the securities business, or an institutional investor, declared broad public participation the sine qua non of a successful auction market as a pricing mechanism, as a crucial part of the process of raising and allocating capital, and as a system for sound, liquid investment. We agree.

The Subcommittee finds that any registered broker-dealer who meets prescribed capital and competency standards should be permitted to join any registered national securities exchange. Capital and competency should be the exclusive criteria for determining eligibility for exchange membership.

The Subcommittee finds further that no registered broker-dealer should be allowed to perform any brokerage transactions for its affiliated accounts. Thus, we find that institutionally affiliated broker-dealers may become members of any registered national securities exchange, but that they should be precluded from handling any brokerage transactions for their affiliated institutions. We have concluded, however, that this prohibition should not take effect until the breakpoint for competitively determined commission rates has reached the $100,000 level.

While at first blush the Securities and Exchange Commission's pending proposal to require all members of registered national securities exchanges to do at least 80 percent of their brokerage business with nonaffiliated accounts appears to be a step along the path to the Subcommittee's recommendation of a flat prohibition, on closer analysis it appears that the Commission's proposal will cause more harm than good. The Commission's proposal may cause undesirable mergers, might have adverse impacts on regional brokerage firms, seems likely to create devilish bookkeeping problems for the securities industry and might have the effect of inducing brokerage firms to churn public customers' accounts in order to meet applicable percentage requirements. After careful consideration, therefore, the Subcommittee has concluded that the Commission's proposed percentage test is contrary to the public interest and should not be adopted.

In its February Policy Statement, the SEC defined "affiliated accounts" in such a manner so as to include pension funds as well as related insurance companies, mutual funds and banks. The dollar amount of pension funds under management far exceeds that of mutual funds and is growing at an increasing rate. When the New York Stock Exchange released proposed rules to "implement" the SEC's February Policy Statement, pension funds were characterized as unaffiliated business. The Subcommittee finds that the distinction the Exchange has attempted to draw between pension funds and mutual funds is spurious and our legislation will define affiliated accounts along the lines of the SEC's February Policy Statement.

The Subcommittee believes that an additional measure is also appropriate. Section 17 of the Investment Company Act of 1940 prohibits a broker-dealer from acting as principal in any transaction with an affiliated investment company. Such a prohibition appears to be sound and should, by appropriate legislation, be extended to apply to other types of managed accounts such as pension and other employee benefit funds.

11. Relationship between the securities laws and the antitrust laws

The Subcommittee believes that Congress should consider whether treble damages in antitrust actions challenging exchange rules should be mandatory or discretionary with the district court judge. Aside from this one area we believe that no legislation is needed.

It has been argued that the court decisions on the relationship of the Federal securities laws and the Federal antitrust laws leave the question of antitrust immunity for national securities exchanges unclear. The Subcommittee believes that the court decisions are in fact clear and correct. Such decisions are fully discussed in Chapter XIII of this report.

As we read the cases, they provide that rules, policies, practices, and actions of national securities exchanges are immune from the antitrust laws to the extent necessary to make the securities laws work, and then only to the minimum extent. Moreover, the courts have held, correctly in our view, that the supervisory presence of the SEC cannot divest the courts of their power to enforce the antitrust laws. In this connection, the courts have retained jurisdiction to decide antitrust matters involving exchange rules instead of referring these matters to the Commission for its initial determination. This is the procedure urged upon the courts by the Department of Justice and, we believe, the correct procedure to follow. The courts do have the benefit of the Commission's views in deciding these matters, however, since the Commission can, and usually does, file friend of the court briefs in any and all such actions. Indeed, the Commission has gone further in one such case and has intervened as a party.

The exchanges argue that the possibility of antitrust liabilities has a chilling effect on their cooperative regulatory activities. In reviewing the antitrust actions in which the five major exchanges are now parties, we note that few of these actions are brought to challenge practices of the exchange having to do with such regulatory activities as the prevention of fraud or manipulation. Rather, the great bulk of these lawsuits have been brought to challenge rules of the exchanges which the Department of Justice has characterized as "not designed to protect the investing public, but rather to protect the economic interests of the particular exchange community." We can see no reason why such rules should be shielded from antitrust scrutiny.

It has been argued that it is not fair to impose mandatory treble damages in actions challenging exchange rules which have been reviewed by the SEC pursuant to its rule 17a–8. It has been suggested that the requirement of mandatory treble damages in such actions might influence the decision of the district court on the merits. On the other hand, it is argued that the threat of mandatory treble damages is an effective deterrent against anticompetitive practices. As already in-

Before stating the Subcommittee's conclusions, it is necessary to define terms. Unless the context indicates to the contrary, the phrase "public business" is used in this chapter to mean non-institutional or individual investor business. "Institutional investors" include pension and other employee benefit funds, mutual funds (including their advisers), insurance companies and banks.

The Subcommittee finds: (1) That there should be a statutory prohibition against any broker-dealer engaging in brokerage transactions for its affiliated accounts; and (2) that any registered broker-dealer who meets prescribed capital and competency standards should be permitted to join any registered national securities exchange. Capital and competency should be the exclusive criteria for determining eligibility for exchange membership.

Thus we find that institutionally affiliated broker-dealers may become members of any registered national securities exchange, but that they should be precluded from handling any brokerage transactions for their affiliated institutions. Current exchange members would, of course, be similarly precluded from performing brokerage functions for their affiliated accounts.

To implement its findings, the Subcommittee recommends appropriate amendments to the Securities Exchange Act and the repealing of Section 17(e)(2) of the Investment Company Act.

B. Prohibition on Brokerage Transactions for Affiliated Accounts

Acting as broker-dealer and as money manager (e.g., for investment companies, pension funds or other such accounts) involves inherent conflicts of interest. For example, a broker may be tempted to "churn" a managed account in order to extract increased commissions from a larger volume of trades.[4] Should a broker handle business both for managed accounts and for the public, the latter may be discriminated against, if, for example, a broker executes a "sell" recommendation for managed accounts and purchases the same securities for public discretionary accounts,[5] or if managed accounts are favored with advance receipt of valuable research, which may be acted upon prior to its being made available to other public customers.[6] Broker-dealers who act as money managers may also engage in a practice known as "scalping," i.e., purchasing securities for a broker's own investment account before using investment discretion to buy the same securities for a managed account; then, after the market has risen as a result of the buying thus generated, selling out his own investment position at a

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[4] For a discussion of "churning," see the Special Study, Pt. 1, pp. 297–298. See also Note, Churning of Securities Dealers, 80 Harv. L. Rev. 869 (1967). "Churning" is expressly prohibited by rule. See rule 15c1-7.

[5] For a discussion of conflicts of interest where a broker-dealer acts as an investment adviser see the Special Study, Pt. 1, pp. 371–74. Investment advisers have both a common law and a statutory duty to disclose to clients existence of facts which have a bearing on the desirability of the transaction from the viewpoint of the principal. See 3 Loss 1503–04 (1969), citing 2 Restatement of Agency 2d § 390, Comment a and Investment Advisers Act, Section 206. See also Id. at 1515–18.

[6] It has been found that investment advisors often discriminate in favor of institutional and other favored customers in making research available on an advance basis. See Special Study, Pt. 1, pp. 357, 373. See also *SEC* v. *Todd*, Litig. Rel. No. 373, 15 SEC Ann. Rep. 161 (D. Mass. 1946) (broker-dealer favoring one class of customers at the expense of other class of customers).

profit. "Scalping" is clearly unlawful.[7] Broker-dealer money managers may fail to obtain "best execution" for managed accounts, in order to favor their own pecuniary interests in obtaining commissions through reciprocal arrangements.[8] Or such broker-dealers may use managed or discretionary accounts as vehicles for absorbing positions in securities which otherwise might have been difficult for their affiliated accounts to dispose of.[9] Finally, to the extent that competitively determined commission rates are in effect, broker-dealer money managers may be in a conflict of interest position as to "negotiating" the appropriate commission to be charged in a transaction for a managed account.[10] The Subcommittee has been urged, therefore, to propose legislation requiring the complete separation of brokerage and money management.

On the other hand, we have heard testimony that conflicts of interest are endemic to the securities business, that the conflicts described above have been handled reasonably well by the brokerage community and that therefore no legislation is needed. It is also argued that broker-dealers should be allowed to diversify their business so that they may earn income from a relatively stable source, such as money management, to counterbalance fluctuations in income obtained from the more cyclical brokerage end of their operations. Moreover, it is argued that because of their experience, broker-dealers can perform valuable money management services for those who desire them.

The Subcommittee finds that there is no necessity to require that broker-dealers choose between the brokerage or the money management business. We find, however, that the conflicts are significant enough to warrant amending the Securities Exchange Act to prohibit registered broker-dealers from directly or indirectly performing brokerage transactions for their affiliated accounts. To implement this recommendation, it may also be necessary to repeal Section 17(e)(2) of the Investment Company Act of 1940. Thus broker-dealers could choose to manage certain accounts with the knowledge that they could not engage in brokerage transactions for those accounts, while electing not to manage other accounts in the hope that they could obtain brokerage business from them.[11]

The Subcommittee believes that an additional measure is also appropriate. Section 17 of the Investment Company Act of 1940 prohibits a broker-dealer from acting as principal in any transaction with an affiliated investment company. Such a prohibition appears to be sound and should, by appropriate legislation, be ex-

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[7] See generally 3 Loss 1559 (stating that scalping constitutes a violation of Section 9 of the Securities Exchange Act). See also *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) and Comment, *The Regulation of Investment Advice: Subscription Advisers and Fiduciary Duties*, 63 Mich. L. Rev. 1220 (1965) and other authorities collected in 6 Loss 3735 (1969). Similarly, where a broker-dealer fails to disclose to a customer that he acts as market-maker in securities recommended by him, this has been held to be a violation of Rule 10b–5. See *Chasins* v. *Smith Barney & Co., Inc.*, 438 F. 2d 1167 (C.A. 2, 1971).

[8] See Statement of Ernest L. Folk III, at Hearings, p. 3181. See also Hearings, pp. 4024–4027 and Welles, "Should Money Management and Brokerage Be Separated?" Institutional Investor (June 1971), at p. 22.

[9] Id.

[10] Id.

[11] It has been argued that broker-dealers who manage investment companies may have difficulty in divesting themselves of the advisory contracts, should they choose to do so, because of the decision in *Rosenfeld* v. *Black*, 445 F. 2d 1337 (C.A. 2, 1971). H.R. 15304 (92d Cong., 2d Sess. 1972), currently pending before this Subcommittee, deals with this question.

tended to apply to other types of managed accounts such as pension and other employee benefit funds.

Since there are now a number of broker-dealers who perform brokerage services for their affiliated accounts, some reasonable period of time should be provided to allow those firms to adjust their practices. In arriving at a suitable interval the Subcommittee is aware that some broker-dealers who are members of regional exchanges engage in brokerage transactions for affiliated institutions to effect cost savings for those institutions. With the lowering of the breakpoint for competitively determined rates to the $100,000 level, and below, such methods of deriving realistic commission costs will no longer be necessary. **Thus it appears reasonable to set the effective date of the proposed prohibition sometime after the breakpoint has reached the $100,000 level, which shall be no later than April 1974.**

Concern has been expressed, however, that unless the prohibition is imposed immediately large numbers of institutions will form brokerage subsidiaries to join regional exchanges so as to reduce the institution's commission costs, thus depriving the brokerage community of needed revenue.[12] But we believe this fear to be unjustified. In Chapter XI, the Subcommittee calls for a further reduction in the breakpoint for competitively determined commission rates in October of this year. There is general agreement that, as the breakpoint for competitive rates approaches the $100,000 level, most institutional transactions will be subject to competitive rates, and thus there will be little to "recapture."[13] With the reduction in the breakpoint called for by the Subcommittee above, we believe that few if any institutions will incur the expense of forming a brokerage subsidiary for "recapture" purposes, knowing that such activities will become illegal around April 1974.[14]

The question remains as to how to define "nonaffiliated" and "affiliated" accounts. One definition was proposed by the SEC's February Policy Statement:

> Nonaffiliated persons include individual discretionary and nondiscretionary accounts and the accounts of non-affiliated institutions, but do not include institutional parents or investment companies or other institutional funds which are managed under contracts or arrangements which give the brokerage firm investment discretion.[15]

Under this definition pension funds managed under contracts or arrangements which give a brokerage firm investment discretion would properly be included as affiliated accounts, as would related insurance companies, mutual funds and banks.[16]

The dollar amount of pension funds under management far exceeds that of mutual funds, and is growing at an increasing rate.[17] It is not surprising, therefore, that when the New York Stock Exchange re-

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[12] Hearings, pp. 4191–4194.

[13] See Hearings, pp. 3693, 3714, 3778, 3804, 3978, 3992, 4034, 4122, 4201.

[14] *Moses* v. *Burgin*, 445 F. 2d 369 (C.A. 1), *certiorari denied*, 404 U.S. 994 (1971), is not to the contrary. That case was decided in an environment of fixed minimum commission rates and held that if recapture was practical then it was required. Under a competitively determined commission rate system, however, there is nothing to recapture and thus the case becomes meaningless.

[15] Hearings, p. 3457.

[16] The Subcommittee includes banks because there currently exist bank-affiliated broker-dealers. Such inclusion is not intended to pass upon the legality of this affiliation under the Glass-Steagall Act, 12 U.S.C. §§ 24, 78, 377, 378, a question not reached by this Study.

[17] Hearing, p. 4282.

leased proposed rules to "implement" the SEC's February Policy Statement, pension funds were characterized as unaffiliated business.[18]

The Subcommittee finds that the distinction the Exchange has attempted to draw between pension funds and mutual funds is spurious. As the chief executive officer of one New York Stock Exchange member firm candidly admitted:

> I think if you are in the business of managing money for an institution . . . then a pension fund would fall in that category.
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> * * * * * * *
>
> It seems we are wrapping ourselves up like an octopus, trying to save a piece of business so that we can construct some definition for it that may escape under the rug somewhere when we try to get the pension fund in there.[19]

The Subcommittee's legislation will, therefore, define affiliated business along the lines of the SEC's February Policy Statement.

In addition to solving the conflict of interest problems, the prohibition on performing brokerage functions for affiliated accounts will also solve the competitive inequities that now exist in the competition for pension fund management business between member firm money managers and money managers that do not have broker-dealer affiliates. Pension and other employee benefit plans are the fastest growing segment of the money management business, and there is a vigorous battle going on for this business. In this battle, member firms have a competitive advantage since they can, and do, credit the brokerage generated by these managed accounts against the advisory fee they charge these accounts. Money managers not affiliated with a broker-dealer cannot, of course, offer such a discount.[20] Although the New York Stock Exchange has recently proposed to amend its rules to prohibit member firms from crediting brokerage against advisory fees, this does not solve the problem, since member firms would still be allowed to do the business for the brokerage generated alone and charge no advisory fee at all.[21] Thus, under the Exchange's proposal, the competitive inequity continues. Under the Subcommittee's proposal, however, there would no longer be competitive inequities, since no money manager, whether or not a member firm, would be allowed to handle an affiliated account's brokerage.

A word is in order about the SEC's pending proposal to require all members of registered national securities exchanges to do at least 80 percent of their brokerage business with nonaffiliated accounts.[22] While at first blush this proposal appears to be a step along the path to the Subcommittee's recommendation of a flat prohibition, on closer analysis it appears that the Commission's proposal will cause more harm than good.

The Department of Justice testified that one result of the Commission's proposed percentage test "is likely to be a wave of mergers between institutional investors and leading brokerage firms that are already members on an exchange. *This would not be desirable.*"[23] The Subcommittee concurs. While we believe that institutions should not be prohibited from investing in the securities industry should they

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[18] Hearings, pp. 4122–4123; 4153, New York Stock Exchange Special Membership Bulletin dated April 20, 1972.
[19] Hearings, p. 4173.
[20] Hearings, pp. 3992, 4071–4072, 4302–4303.
[21] Hearings, pp. 4176–4177, 4232.
[22] Securities Exchange Act Release No. 9716 (Aug. 3, 1972).
[23] Hearings, p. 4119 (emphasis added).

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SECURITIES INDUSTRY STUDY

REPORT

OF THE

SUBCOMMITTEE ON SECURITIES

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

April 6, 1973—Ordered To Be Printed

> member organization including its approved corporate affiliates and subsidiaries, or its parent, as the case may be, acts as a Floor trader, specialist, so-called "two dollar broker," odd lot broker, arbitrageur, or holds itself out to, and transacts business generally with, the public as a broker or dealer in securities. . . . A member organization's, or its parent's "primary purpose" shall be presumed to be the transaction of business as a broker or dealer in securities if its gross income . . . from activities of the type described in the preceding sentence and from interest charges imposed with respect to debit balances in customers' accounts is at least 50% of its total gross income. . . .[45]

It should be noted that this rule does not include income from investment advisory and investment company management activities as income which is of a type qualifying to meet the primary purpose test. However, brokerage income received by member firms in lieu of fees from advisory accounts managed by them is included.

Under this rule, most institutions cannot themselves qualify for Exchange membership because 50% of their total gross income is not attributable to broker-dealer activities of the type described in Rule 318.12. This is true even if such institutions are registered as broker-dealers under the Exchange Act. As noted, income from investment advisory and investment company management activities is not considered broker-dealer revenue, even though such activities represent a substantial part of the business of many NYSE member firms.

Furthermore, this rule precludes a broker-dealer subsidiary of an institution from membership, even if such subsidiary itself meets the primary purpose test, unless the "parent" institution can also meet the primary purpose test. Thus, institutions cannot obtain membership by organizing or acquiring a broker-dealer subsidiary.

ii. Pacific Coast Stock Exchange

The Pacific Coast Stock Exchange was the first regional stock exchange to admit subsidiaries of institutional investors to membership. In 1965 it admitted Kansas City Securities, the brokerage affiliate of Waddell & Reed, Inc., a large mutual fund manager.[46] At the time, the PCSE did not have any rule prohibiting member firms from being controlled by publicly held companies. Within a year of the admission of Kansas City Securities, the Exchange admitted the subsidiaries of three other mutual fund advisors: IDS Securities Corporation, a subsidiary of Investors Diversified Services, Inc.; Emmet A. Larkin Co., a subsidiary of Channing Co., Inc.; and Imperial Securities, Inc., a subsidiary of Imperial Financial Services, Inc.

After the admission of these members, the exchange revised its criteria for membership to prevent subsidiaries of mutual fund advisors from becoming members unless the shares of the mutual fund were sold to the public through a captive sales force rather than through broker-dealers.[47] This restriction was designed to prevent the broker-distributed funds from recapturing the commissions which they might

[45] NYSE Rule 318.12.
[46] 4 Institutional Investor Study, *supra* note 10, at 2309.
[47] *Id.* at 2309.

otherwise instruct the executing broker to "give up" to other exchange members who sold the fund's shares.[48] Before the end of 1965, the Exchange further modified its rules to exclude any firms controlled by persons outside the securities business. However, a grandfather clause was included which prevented the expulsion of existing members who were so controlled.[49]

The present PCSE membership rules have moved closer to those of the NYSE. They state that, except with the approval of the Board of Governors, all active stockholders of a corporate member firm shall be active in the business and this requirement—

> shall not be deemed to be met in any case where a voting stockholder is a corporation unless the principal business of that corporation and its parent, subsidiaries and affiliated organizations taken on a consolidated basis shall be that of a bona fide broker-dealer in securities. A parent or subsidiary of an affiliated organization may be excluded from such consolidation upon terms and conditions as the Board of Governors may require.[50]

Nevertheless, the PCSE still has eighteen institutional members.[51]

iii. Midwest Stock Exchange

The rules of the Midwest Stock Exchange prior to 1970 explicitly barred institutions from membership.[52]

In 1970, the MSE revised its rules to permit its members to obtain public financing. The revised rules do not restrict the kind of institution which may own or control a member firm. The MSE does require, however, that the member firm conduct a "general" securities business primarily with the "public" and not with its parent. An organization can be a member only if—

> at least 50 percent of all brokerage commissions earned by the member organization on the Exchange is from transactions for customers other than affiliates, and at least 50 percent of the member organization's gross income from its entire securities business is derived from business with or for customers other than affiliates.[53]

The MSE rules do contain provisions regarding parents. Like the NYSE, the MSE retains the right of disapproval of principal stockholders—including parent firms—of member organizations.[54] However, the MSE, unlike the NYSE, does not automatically disapprove any parent which is not primarily a broker-dealer. There must be "affirmative grounds" for such disapproval.[55]

iv. PBW Stock Exchange

In 1967, the PBW (formerly the Philadelphia-Baltimore-Washington) Stock Exchange made the internal policy decision that its rules did not prohibit membership to institutional affiliates or impose

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[48] 4 Institutional Investor Study, *supra* note 3, at 2300.
[49] PCSE, rule IX, § 3 adopted July 1, 1965.
[50] PCSE, rule IX, § 5(a).
[51] 4 Institutional Investor Study, *supra* note 3, at 2310.
[52] MSE Rules, Art. XV, rule 7. This section was modified in 1970.
[53] MSE Constitution, Art. I, rule 1(c)(1).
[54] Letter from Michael E. Tobin to *See* Division of Trading and Markets, January 12, 1970 at 1.
[55] MSE Constitution Art. XV, rule 6.

requirements as to the type of business in which the parent organizations may engage.

As a result, early in 1968 the PBW began admitting subsidiaries of financial institutions to membership. The PBW has continued ever since to accept and even to solicit such applicants. As a result the PBW now has a large number of members who are subsidiaries of institutional investors. Of a total of 295 member organizations, 38 (or approximately 16%) are brokerage affiliates of financial institutions.[56]

In its rules on membership, the PBW, like the MSE,[57] does not concern itself with the business of the parent. However, unlike the MSE, it also does not limit the amount of business the member firm can do with its parent. The Exchange has extended certain of its regulatory controls over the parents of member firms by reserving the right to examine the books and records of the parent and any of its affiliates, as well as by reserving the power to compel a member firm to sever connections with its parent.[58] And while the Exchange does not require that the "primary purpose" of the parent must be the transaction of business as a broker or dealer in securities, its constitution does apply a "primary purpose" test to the member firm itself.[59]

2. PROBLEMS RESULTING FROM COMBINATION OF MONEY MANAGEMENT AND BROKERAGE

The combination of money management and brokerage under the differing rules of the various stock exchanges has created a number of difficulties. These difficulties fall into three basic categories: (1) impediments to fair competition between money managers; (2) conflicts of interest; and (3) distortion in the evolution of the central market system.

a. Barriers to Fair Competition Between Money Managers

As noted above,[60] different stock exchanges take different approaches toward the combination of money management and brokerage. In some cases these rules discriminate between firms which are in essentially similar businesses, admitting some and barring others solely upon the basis of differences in the percentage of the firm's income which is derived from one line of business or another. A firm which receives 49% of its gross income from money management and 51% from brokerage and related activities[61] is eligible for NYSE membership. A firm which receives only 49% of its income from brokerage is not eligible for membership.

This discrimination gives exchange members who want to enter the money management business a competitive advantage over money managers who are unable to join exchanges. This competitive ad-

[56] 2 Securities Industry Study Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs, 92d Cong., 1st Sess. (1971) at 215 (hereinafter cited as "Study Hearings"). Parts 1-2 of these hearings were held in the 1st Session of the 92d Congress, parts 3-4 were held in the 2d session.

[57] See text at fns. 52-55 *supra*.

[58] Statement of the PBW Stock Exchange, SEC. Market Structure Hearings, *supra* note 23, at 3 (October 1971).

[59] PBW Constitution, Art. XIV, § 2.

[60] *See* § C.1.d., *supra*.

[61] Fees received for money management services are not considered to be income from the transaction of business as a broker or dealer in securities although brokerage commissions received in lieu of such fees are. NYSE Rule 318.12.

it would limit the brokerage-money management combination to firms primarily engaged in performing brokerage services, its principal impact would fall on those relationships which do not give rise to conflicts of interest—namely those in which the affiliated broker does business only for the managed account and passes all its profits back to that account. Furthermore, Martin's failure to connect the issues of competitive commissions and institutional membership also neglects the fact that most of the conflicts are aggravated by the existence of fixed commissions.

While the Martin proposals would eliminate the economic problems resulting from differing rules regarding membership, and the market distortion which this has created, they fail to deal with the broad competitive advantage exchange members have in competing for money management. Indeed, except with respect to investment companies, it seeks to perpetuate this competitive favoritism by governmental action. Exchange members would be free to realize profits from two sources—a management fee and commission income—but money managers would be barred from earning commisson income.

In an attempt to eliminate the most obvious symptom of this competitive inequality, Martin would prohibit member firms "from crediting commissions against any fee charged for investment advice." [86] But Martin does not propose, nor has anyone else seriously suggested, that a fixed minimum advisory fee be established at a level which would make advisory business profitable in its own right. Therefore, exchange members in setting advisory fees may take into account expected commission income from the managed account or, in fact, may charge no advisory fee whatsoever.

b. The SEC Approach

The SEC's analysis of the problem of institutional membership proceeds from premises quite different from those advanced by Martin. The SEC asserts that the problems created by the combination of money management and brokerage are: (1) the recapture of commissions which is made possible by the combination of money management and brokerage and (2) the possibility of the use of exchange membership for "private purposes."

In its Statement on the Future Structure of the Securities Markets the SEC described these two problems in the following terms:

> Certain regulatory problems arise out of the relationships created by institutional membership. The first stems from the existence of a structure of fixed minimum commissions. So long as such a structure exists, large investors should not, by virtue of their economic power and size, be entitled to obtain rebates of commissions not available to other investors. While fixed minimum commissions exist, they should apply to all investors, and an exception should not be given to a particular person. Institutional membership, however, provides a vehicle for obtaining rebates, either directly or indirectly.
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> Second, institutional membership may result, to a greater or lesser degree depending on the circumstances, in the use

[86] Martin Report at 18.

> of exchange membership for private purposes rather than for the purpose of serving the public in an agency capacity or otherwise performing a useful market function. In part, this problem is similar to that discussed in the preceding paragraph: the problem of using exchange membership as a means of obtaining a reduced commission rate. But the problem of using exchange facilities for private purposes is broader in scope than the rate question. For we believe that membership in the market system should be confined to firms whose primary purpose is to serve the public as brokers or market makers. Stock exchanges are affected with an overriding national interest which demands that they act to maintain and improve the public's confidence that the exchange markets are operated fairly and openly. The public should have the assurance that a member of an exchange is dedicated to serving the public, and membership by institutions not predominantly serving non-affiliated customers should not be permitted to cloud this objective.[87]

The premise which appears to underlie the SEC's first point is that the combination of money management and brokerage is permissible unless it results in benefits for the managed account, in the form of reduced commission expense, in which case it must be prohibited.

The SEC found that there was no basis for denying exchange membership to a brokerage firm solely because it is a subsidiary or affiliate of a money manager, but that the relationship between the money manager and the broker should be limited to eliminate the practices it found undesirable. To do this the SEC proposed a "predominant purpose" test.[88] This test would allow money managers to join exchanges and do the brokerage for institutional accounts which they manage only if a predominant portion of their brokerage business were done with unaffiliated customers.

While the Market Structure Statement did not contain a statement of what constituted a "predominant" portion, the SEC soon thereafter indicated that it thought 80% was appropriate.[89]

In its Market Structure Report the SEC defined non-affiliated accounts as including:

> individual discretionary and non-discretionary accounts and the accounts of non-affiliated institutions, but do not include institutional parents or investment companies or other institutional funds which are managed under contracts or arrangements which give the brokerage firm investment discretion.[90]

This definition included pension funds in the class of affiliated accounts because they are customarily managed under arrangements which give the brokerage firm investment discretion.[91]

The SEC first sought to implement its proposal through the voluntary cooperation of the securities exchanges. On February 15, 1972,

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[87] SEC Statement on the Future Structure of the Securities Markets 21 (1972) (hereinafter cited as "Market Statement").
[88] *Id.* at 23.
[89] Letter from the SEC to all registered national securities exchanges, Feb. 15, 1972.
[90] Market Statement at 23.
[91] Letter from Donaldson, Lufkin & Jenrette, Inc. to SEC, Oct. 2, 1972.

the SEC sent a letter to all of the registered exchanges calling upon them to adopt rules:

1. Prohibiting membership for firms whose primary function is to rebate, recapture, or redirect commissions.
2. Eliminating any parent test that presently exists.
3. Restricting membership to firms doing the predominant portion of their brokerage business on registered national securities exchanges for nonaffiliated customers.[92]

The NYSE promptly indicated its agreement in principle with the SEC's proposals.[93] The regional exchanges, however, raised objections. The reluctance of the Pacific Coast Stock Exchange and the Midwest Stock Exchange seemed to stem at least in part from the fear of antitrust liability which might result in the event they took voluntary action to expel one class of members without a binding SEC directive.[94] The PBW Stock Exchange, which has been a leader in permitting unrestricted institutional membership, refused to acquiesce on broader grounds, asserting that the proposals were both unnecessary and beyond the SEC's authority.[95]

On March 10, the SEC indicated its intention to proceed and requested all exchanges to send it "all data, views and drafts of rules which you would like to have us consider."[96]

On May 26, 1972 the SEC formally requested the exchanges to adopt as their own a rule promulgated by the SEC concerning institutional membership.[97] While the SEC's proposal generally followed the position taken in its Market Structure Statement it differed from the earlier position in one significant respect. Originally, the SEC suggested that pension funds be included in affiliated business.[98] However, the May 26 proposal defined affiliation in a manner which made pension funds unaffiliated if managed under the arrangements most commonly used by brokers, but affiliated if managed pursuant to the arrangements most commonly used by insurance companies.[99]

Although the suggestion for this change came from the NYSE,[100] the SEC has not explained why it accepted the NYSE position in preference to the position it had expressed in its Market Structure Statement. Because of the fact that pension funds are the largest and fastest growing category of institutional business, this change of position has a substantial impact on the competition between NYSE members and non-members for the management of pension fund accounts.[101]

In the face of continued opposition, the SEC moved to impose its rule upon the exchanges by using its power under section 19(b) of the

[92] Letter from the SEC to the President of all registered national securities exchanges, Feb. 15, 1972.
[93] Letter from the NYSE to the SEC, Feb. 17, 1972.
[94] Letter from the Midwest Stock Exchange to the SEC, Feb. 24, 1972; letter from the Pacific Coast Stock Exchange to the SEC, Feb. 25, 1972.
[95] Letter from the PBW Stock Exchange to the SEC, Mar. 2, 1972.
[96] Letter from the SEC to all registered national securities exchanges, Mar. 10, 1972.
[97] SEC, Sec. Ex. Act Rel. No. 9623 (May 30, 1972).
[98] Market Statement at 23. *See* text at notes 90-91, *supra*.
[99] Testimony of Jerome Grossman, 8 House Hearings at 4152-53. This is so because stock exchange firms typically manage pension funds under arrangements that give them only investment discretion whereas insurance companies usually manage pension funds pursuant to a contractual arrangement. The ultimate consequences of these two modes are the same: The money manager has the de facto authority to make the day-to-day investment decisions for the managed account. However, Rule 19b-2 would apparently treat these two situations differently by relying heavily on the existence of a contractual arrangement to determine "affiliation", thus disregarding the realities of the situation. *See generally* 8 House Hearings 4029-4203.
[100] *See* NYSE Special Membership Bull., April 20, 1972.
[101] *See* Chapter I.C.1.c. ii, *supra* and sources cited therein.

Securities Exchange Act.[102] Attempting to avert the delay inherent in an adversary proceeding—in which factual questions are developed and resolved through evidentiary hearings with interested parties afforded the right of cross-examination—the SEC sought to act through a rulemaking procedure. On August 3, 1972, it proposed to adopt a new Rule 19b–2 which would, in effect, require all registered securities exchanges to adopt rules implementing the SEC's predominant purpose test.[103]

The legality of the procedure which the SEC is using to attempt to reach its goals has been called into question, as has the SEC's statutory authority to deal with the question of membership at all.[104]

In the fall of 1972 the SEC held public hearings upon its proposed Rule 19b–2.[105] At these hearings, interested persons were invited to comment on the rule proposal but were not permitted to cross-examine proponents of the rule or of the view point. On January 16, 1973 the SEC promulgated Rule 19b–2 substantially in the form proposed in August except that a three-year phase-in period was allowed for firms which were exchange members on January 16.[106] Rule 19b–2 requires all registered national exchanges to adopt, by March 15, 1973, rules following the exact language of SEC Rule 19b–2.

The Antitrust Division of the Department of Justice, among others, has taken the position that the type of hearing held in connection with the promulgation of Rule 19b–2 did not satisfy the hearing requirements of section 19(b) of the Exchange Act or of the Administrative Procedure Act.[107] While the SEC may succeed in forcing the exchanges to adopt rules consistent with its proposals, the possibility exists that its attempt will be resisted by one exchange or another.[108] Moreover, even if the exchanges acquiesce, affected members may yet attack the rules in court. In short, the SEC's proposals and action may well be subjected to court test and protracted litigation.[109] Chairman Casey has estimated that it may take two years for the SEC to put its rule into effect, assuming that both its procedure and the substance of the rule can withstand judicial scrutiny.[110]

In addition to the procedural questions raised by the manner in which Rule 19b–2 was adopted, there are a number of problems with the Rule itself.

(1) One of the SEC's acknowledged purposes is to prohibit the use of exchange membership to reduce the commissions levied on insti-

[102] The so-called 19(b) power is described *infra* in Chapter III.C.

[103] SEC, Sec. Ex. Act. Rel. No. 9716 (Aug. 3, 1972).

[104] *See* Letter from Wolf, Block, Schorr & Solis-Cohen to SEC, Sept. 8, 1972; Comment of the United States Department of Justice in response to SEC Release 9716 (Oct. 3, 1972).

[105] Matter of Proposed Securities Exchange Act Rule 19b–2, SEC File No. S7–452 (1972) (hereinafter cited as "19b–2 Hearings").

[106] SEC Sec. Ex. Act Rel. No. 9966 (Jan. 16, 1973).

[107] Comment of the United States Department of Justice, *supra* note 104.

[108] On November 28, 1972 the PBW indicated that it would not challenge the SEC's proposed Rule 19b–2 in the courts if a phase-in-period were allowed. Testimony of E. Wetherill, 19 b–2 Hearings (Nov. 29, 1972). While the rule as adopted contains a phase-in-period, it is unclear as to whether the conditions governing it meet the PBW's objections. Press reports indicate that the possibility still exists of one exchange or another challenging Rule 19b–2 in the courts. *See Stock Exchange ordered to Admit Institution Firms*, The N.Y. Times, Jan. 17, 1973, p. 1 col. 4.

[109] The Treasurer of the State of Connecticut among others has indicated his displeasure with Rule 19b–2 in the strongest terms and suggested the possibility of legal action. Testimony of R. Berdon, 19b–2 Hearings (Dec. 1, 1972).

[110] Testimony of William Casey, 1 Institutional Membership Hearings at 146. Since the time of this testimony, the PBW Stock Exchange has stated that it will not contest Rule 19b–2 in the courts if certain conditions are met. *See* note 108, *supra*.

tutional transactions under the fixed commission rate schedule.[111] The SEC recognizes that the question of institutional membership is inseparable from the question of commissions on institutional transactions and that the pressures for such membership will decline under a competitive system.[112] Fixed commissions on institutional-sized transactions are now being phased out.[113] Currently, it appears that the phase-out will be finished in little more than a year. When it is, there will be no more excess commission charges to recapture. The SEC is, thus, devoting enormous amounts of energy to eliminating a problem which will shortly be eliminated by other methods. Therefore, if Rule 19b–2 is designed to shore up the fixed commission rate structure, it not only contradicts the SEC's own policy in favor of price competition on institutional transactions, but also overlooks the fact that this aspect of the institutional membership question really has relatively little long-term importance.

(2) The SEC's approach does nothing to reduce the conflicts of interest which exist by virtue of the combination of money management and brokerage.[114] Indeed, the SEC's approach can only exacerbate and make more widespread the conflicts which already exist: by requiring all money managers who execute transactions for affiliated accounts to do business with unaffiliated accounts as well, Rule 19b–2 makes universal the opportunity for a money manager to favor one type of customer over another. Moreover, in order to meet the 80% requirement, a broker might well be tempted to churn his unaffiliated accounts or, conversely, to artificially limit transactions by affiliated accounts in order to keep the trading for affiliated accounts below 20%.

(3) Rule 19b–2 fails to come to grips with the fundamental unfairness in the current situation which permits brokers to combine money management with their brokerage business but prohibits money managers from combining brokerage with their money management business. Gustave Levy, a former NYSE Chairman, has expressed this unfairness succinctly:

> Our Achilles' heel has always been that we have been in the money managing business and the money managers could not get into ours.[115]

Under the SEC's proposal, a firm which does mostly money management will be barred from doing brokerage for managed accounts, but a firm which does mostly brokerage can also do brokerage for managed accounts. There is no justification for this anti-competitive discrimination.

(4) The predominant purpose test, the percentage formula and the definition of affiliation proposed by the SEC will cause firms to structure their relationships with their managed accounts artificially

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[111] This represents an unexplained alteration of the position taken by the SEC in several court cases involving the failure of mutual fund advisors to make use of membership to reduce commission charges paid by the funds they manage. *See, e.g.*, Memorandum of the SEC as Amicus Curiae, Gross v. Moses, 67 Civ. 4186 U.S.D.C. S.D.N.Y. (August 1971). The SEC took the position that where recapture of commissions is available through regional exchange membership, mutual fund managers must at least make a bona fide judgment as to whether to establish a brokerage affiliate to recapture commissions for the fund.

[112] Testimony of William Casey, 1 Study Hearings at 102. Chairman Casey stated that the question of fixed commissions and institutional membership were "completely, but not utterly" entwined.

[113] See Chapter I.B., *supra*.

[114] The SEC takes the position that conflicts are inevitable in the combination of money management and brokerage. Without analyzing the effect its own proposals will have on these conflicts, the SEC takes the position that if these conflicts are to be dealt with, Congress should do it. Market Statement at 23.

[115] The New York Times, Jan. 27, 1971.

so as to make such accounts appear to be unaffiliated. In dealing with sophisticated investors, the industry displayed great ingenuity in avoiding the fixed commission rate structure.[116] There is little basis to expect that the "mazes of blatant gimmickry" [117] which have been prevalent in recent years can be avoided in the future. Robert W. Fischer, Chief Executive Officer of a regional securities firm, has described this process:

> It seems we are wrapping ourselves up like an octopus, trying to save a piece of the business so that we can construct some definition for it that may escape under the rug somewhere when we try to get the pension fund in there.[118]

(5) While it may well be appropriate to seek to assure that brokers serve public rather than private purposes, Rule 19b–2 does not seem particularly well suited to accomplish this objective. The Antitrust Division aptly described the deficiencies in the SEC's method for determining whether business is "public" or "private":

> The Commission's proposed Rule 19b–2 makes the question of "public" versus "private" business turn on whether the broker is dealing with an "affiliated" person. The definition of "affiliated" person in Rule 19b–2 ignores most of the traditional affiliations of man (e.g., blood and marriage) and ignores some of the traditional affiliations of the securities world (e.g., pension fund management). On the other hand, it emphasizes to the exclusion of others two particular affiliations as being "private": first, the investment advisor mutual fund affiliation; and, secondly, the right to participate in the earnings of a broker to the extent of more than 25%.
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> This definition produces some anomalous results: a broker who represents nobody but four members of his wealthy family is doing a "public" business, and a broker who does nothing but represent a mutual fund with 100,000 shareholders is doing a "private" business.[119]

In short, while the SEC's concern for assuring that the securities markets serve public purposes may be appropriate, the means it has chosen to deal with the question of the combination of money management and brokerage and the use of exchanges for private purposes appear inappropriate to the task.

4. THE SUBCOMMITTEE'S APPROACH—PROHIBITING SELF-DEALING

a. Eliminating the Combination of the Brokerage and Money Management Functions

After extensive consideration of the matter, the Subcommittee is of the view that the question of the combination of money management and brokerage should be resolved by prohibiting stock exchange members and their affiliates from effecting any transactions on national securities exchanges for institutional accounts which they manage.

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[116] *See* Chapter I.B.1. c., *supra*.

[117] Address by Robert W. Haack before the Economic Club of New York, Nov. 17, 1970, *quoted in* The New York Times, Nov 18, 1970, p. 76 col. 8.

[118] 8 House Hearings at 4173.

[119] Comments of the United States Department of Justice in Response to SEC Release No. 9716 (Oct. 3, 1972).

"Institutional accounts" would include the accounts of banks, insurance companies, investment companies, separate accounts, profit-sharing retirement plans, pension benefit plans, foundations and educational endowment funds. The test of "management" for purposes of this prohibition would focus upon the *de facto* authority to make the day-to-day investment decisions for the fund without reference where the ultimate legal responsibility lies for the investment of the institution's assets. This practical test should reduce the danger of evasion of the prohibition through artificially structured arrangements.

The Subcommittee's proposal would deal effectively with most of the previously discussed problems which result from the combination of money management and brokerage functions.

1. By eliminating self-dealing with respect to the brokerage on managed institutional accounts, the conflicts of interest created by that combination, such as churning, choice of market, appropriate commission level, and dumping, will be eliminated.

2. This absolute and uniform prohibition on self-dealing will eliminate the problem of market distortion which arises from the different relationships between money management and brokerage allowed by the various exchanges. The incentive to take transactions to the market which affords the opportunity to earn or recapture the most commission income will be removed. In this way the artificially created market fragmentation resulting from the existing pattern can be eliminated.

3. The Subcommittee's proposal applies even-handedly to all money managers and will, therefore, provide a fair basis upon which all can compete for money management business. The unjustifiable discrimination suffered by non-broker money managers under the existing arrangements will be eliminated.

4. The Subcommittee's proposal will eliminate the artificial inducement to money managers to get into the brokerage business. The elimination of this inducement will permit more flexible movement toward the creation of a new central market system without being frozen into current patterns.

This legislation will not provide the perfect solution for each of the separate problems previously described, but any suggested remedy that would completely eliminate one problem would exacerbate one of the others, or would be so draconian that its burdens would outweigh its advantages. For example, this proposal will not eliminate *all* of the conflicts which arise when a broker has customers with differing interests. A money manager/broker may still be tempted to favor one type of account over another in providing research or may use its knowledge of the portfolio transactions of a managed account to enable its other customers to trade against the managed account.

One way to eliminate almost all of the conflicts would be to prohibit any firm, or group of affiliated firms, from engaging in both brokerage and money management. However, the case has not been made for so drastic and disruptive a step. As noted above, there does not appear to be any evidence of widespread abuse.[120] Such a com-

[120] 41 of the 62 respondents to the Subcommittee's questionnaire concerning institutional membership asserted that there was no evidence of abuse resulting from the combination of brokerage and money management. No respondents cited any examples of abuse. 2 Institutional Membership Hearings at 435 *et seq.*

'ete separation would also deprive the industry of the relatively 'eady income available from money management to offset the cycli- l nature of the commission business, and would eliminate financial stitutions as a source of much needed capital for the brokerage in- stry. It would deprive pooled accounts of the money management pertise of the securities industry.

The Subcommittee's proposal, of course, will do nothing to alleviate whatever problems may exist in connection with the managed or iscretionary accounts of individuals. The Subcommittee has not con- idered this question in depth in the course of this study. However, t appears that there are important distinctions between institutional nd individual accounts. Because individuals receive detailed current nformation about their accounts, unlike the beneficiaries of pooled ac- ounts who receive at best only the most summary reports of their portfolio transactions, individuals are in a better position to protect their interests than the beneficiaries of pooled accounts. Congress has previously recognized this distinction, and voiced its concern for the beneficiaries of pooled accounts, in the Investment Company Act of 1940 and the recent amendments strengthening that Act.

b. Implementation

The legislation proposed above is designed to deal with the prob- lems which the money management/brokerage combination poses for the competitive market of the future. So long as commissions continue to be fixed on institutional-sized transactions, it does not seem ap- propriate to eliminate current efforts by financial institutions to re- capture excessive commission costs exacted from their beneficiaries. Because of this, the prohibition on the combination of brokerage and money management should become effective only after fixed commis- sions on any portion of a transaction over $100,000 have been elim- inated. However, the prohibition should apply immediately with respect to any new affiliations between broker and managed institu- tional accounts.

In addition to deferring effectiveness of the proposal as to existing relationships until the elimination of fixed rates on institutional-sized transactions, the industry may well need a period of adjustment after the elimination of fixed rates. Many present exchange members now rely upon the combined sources of income made available by doing the brokerage on managed accounts. These members should be allowed time to prepare for the separation of functions. While the Subcom- mittee will seek additional testimony on this question, it appears that a two-year graduated phase-in would be appropriate.

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EXCHANGE INSTITUTIONAL MEMBERSHIP RULE

SEC Adoption of Rule 19b-2

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SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

The Securities and Exchange Commission announced today adoption of Rule 19b-2 under the Securities Exchange Act of 1934, a rule governing use of membership on a national securities exchange for other than public purposes. The Commission's rule directs the nation's registered securities exchanges to take action by March 15, 1973, to implement the provisions of the rule within the framework of their own rules and regulations.

In brief, the new rule:

1 - Requires that each member have as its principal purpose the conduct of a public securities business. A member is deemed to have such a public purpose if at least 80% of the value of its transactions meet the standards of the Rule defining public purpose. Transactions with affiliated entities, as defined, or for the member itself, are not treated as public business.

2 - Defines affiliated interests generally in terms of a control relationship between an exchange member and another entity. The Rule also specifically treats as affiliated business that of an investment company--when an exchange

member manages the investment company or when a parent or subsidiary of the member manages the investment company. Also treated as affiliated business are transactions of principal officers, and certain stockholders or partners of an exchange-member firm.

3 - Provides for a three-year phase-in period for existing exchange members not presently conducting a predominantly public business. However, the rule requires these members to file with the exchange within 30 days of implementation of the exchange rule a statement of intent to comply with the rule and a detailed plan for compliance. The rule also requires progress reports and revised plans after each of the first two years of the phase-in period.

In a statement, Chairman William J. Casey said:

"The action of the Commission in adopting Rule 19b-2 on the obligations and purposes of exchange membership is a crucial first step in the restructuring of the securities markets. It is the belief of the Commission, expressed in its policy statement on the future structure of the securities markets, issued almost a year ago, that the emerging central market system should have at its heart a corps of professional brokers and market-makers serving investors. This means that membership on the national exchanges and in the central market system should be open uniformly to any entity meeting

financial and competence standards and whose main purpose is the handling of public orders or otherwise making specific contributions to the market. The many advantages of exchange membership make this requirement essential if the public character of the securities markets is to be preserved.

"While the Rule requires that exchange membership be limited to firms doing a predominantly public business, it also opens membership to any organization which can meet that test, whether or not the primary business of its parent organization is that of securities brokerage. The Commission views this as an opportunity for institutions to diversify by entering the public brokerage business, bringing much needed new capital into that sector and increasing the quality and scope of competition in investor service. Competition will be the essence of the central market system in terms of price, execution and service to public investors. That is why membership should be based on a desire to compete for public orders.

"The Commission's approach in drafting the rule has been one of flexibility. This is a first step, and is not intended to be a final resolution to the problems facing the industry in this area. Our view is that an 80 per cent public business standard, rather than 100 per cent, allows room for change in an industry that is in a period of transition and adjustment. As long as trading by a member for its own account,

or an account in which it has an interest, is merely incidental to the public service performed, the Commission believes the public purpose of Rule 19b-2 will be served. A flexible, administrative approach to the implementation of a public business test is a responsible course which will bring progressive and desirable change and minimize the risk of disruption of the market mechanism.

"As a first step in the implementation of the central market system, we believe this will be followed by other important developments in the coming months as the pieces of the picture fall into place. These elements will include the implementation of a composite transaction reporting system to show and identify trades in listed securities from all markets, followed by a system to display quotations in these securities so orders will flow to the best markets, wherever they are being made within the system. The Commission now has in preparation a White Paper which will detail our present thinking on the elements of the central market system and the work of our industry advisory groups and present a blueprint for implementation."

In finalizing the Rule, the Commission has prepared an extensive release detailing, among other things, the background of its development and its underlying legal basis. This

includes an analysis of the advantages and obligations of exchange membership and a discussion of the intent of Congress in adopting the Securities Exchange Act of 1934 to preserve the public character of the securities markets. The Commission release also traces the extensive background of the exchange membership question, brought out in four years of Commission hearings on major securities industry issues. Out of these hearings, and from our Institutional Investor Study and Study of Unsafe and Unsound Practices of Broker/Dealers, the Commission in February 1972 issued a definitive policy statement on the Future Structure of the Securities Markets. The policy statement called for creation of a central market system, an enlarged sphere for negotiated brokerage commissions, increased competition in quality of services to investors and elimination of the use of exchange memberships for predominantly non-public purposes. At the same time, the February policy statement rejected any continuing need for the so-called parent rules of exchanges barring membership for institutional affiliates, and favored membership for all who could meet the universal test of conducting a predominantly public business.

The Commission first issued a proposed rule on the use of exchange memberships last May 26. On August 3, Rule 19b-2 was published for public comment. On October 5, the Commission

requested supplemental written comments, mainly to permit interested parties to analyze and comment on the initial responses. In November, the Commission held a week of oral presentations to secure additional comment on the Rule from exchanges, institutions, investor groups and other interested parties. The Commission's final release includes an analysis of the Commission's four years of extensive hearings as well as comments received and relates them to the Rule.

In defining public business as transactions for people other than the exchange member itself and those affiliated with the member, Rule 19b-2 cited certain other additional transactions which would fall in the category of public business, including:

. specialist and odd-lot dealer transactions in securities in which they are registered.

. block positioner transactions, unless an affiliated person or organization is a party to the transaction.

. stabilizing transactions in securities distributions.

. bonafide and risk arbitrage transactions.

. transactions arising under exchange plans, which have been declared effective by the SEC, to regulate floor trading.

In describing affiliated interests in terms of controllin relationships between exchange members and other entities,

VII. Utilization of Exchange Membership

A. General

As the preceding sections attest, the issue of "institutional membership" on stock exchanges has been discussed at length by government agencies, stock exchanges, securities industry participants and public representatives. There is no real consistency, however, in the usage of that term. On the New York and American Stock Exchanges, generally thought of as prohibiting institutional membership, many members engage in an investment advisory business and also execute transactions for institutional accounts.277/ On the regional exchanges many subsidiaries of investment managers and insurance companies have purchased seats to trade for the the account of the affiliated "parent" or to be used for "recapture" of commission dollars for that parent.278/ Other institutions have affiliated with bona fide broker-dealer exchange members but execute no transactions through the broker-dealer member. All of these arrangements, while different in many respects,279/ have been referred to as forms of "institutional membership" and fall within the scope of the inquiry upon which Rule 19b-2 is based.

Issues relating to the eligibility of corporate entities, such as financial institutions, for exchange membership can best be understood in the context of exchange rules which bear on that eligibility. Prior to 1970, membership on some exchanges was indirectly restricted by rules which did not permit public or corporate ownership of a member. For example, the New York Stock Exchange Constitution

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277/ See, Commission File No. S7-452, supra n. 16, New York Stock Exchange, Exhibit I.

278/ In 1970, there were at least 55 "institutional memberships" on the regional exchanges. By the end of 1972 that figure had grown to nearly 80. For a description of the manner in which a pure "recapture" vehicle might operate, see Senate Hearings on Institutional Membership, supra n.110, pt. I, at p. 100-104.

279/ See, generally, Institutional Investor Study, supra n. 4 , pt. 4, at pp. 2296-2300.

required that every holder of voting stock of a member be an officer or employee of the member and devote the major portion of his time to its business. When the NYSE adopted rules to permit its member firms to issue freely transferable securities, the Exchange extended its "primary purpose" test to the "parent" of an exchange member.280/ Both the New York and American Stock Exchanges

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280/ The NYSE Rule stated: "The primary purpose of every member organization, and any parent of any member corporation, shall be the transaction of business as a broker or dealer in securities". New York Stock Exchange Rule 318. 2 CCH, New York Stock Exchange Guide Para. 2318 at pp. 3075-77. The business of being a broker or dealer was defined further:

> "For the purposes of this Rule, a member organization's or its parent's activities shall be considered to be the 'transaction of business as a broker or dealer in securities when such member organization including its approved corporate affiliates and subsidiaries, or its parents, as the case may be, acts as a Floor trader, specialist, so-called 'two dollar' broker, odd-lot broker, arbitrageur, or holds itself out to, and transacts business generally with, the public as a broker or dealer in securities. . . if its gross income (including, in the case of a member organization, the gross income of its corporate affiliates and subsidiaries controlled by the member organization) from activities of the type described in the preceding sentence and from interest charges imposed with respect to debit balances in customers' accounts is at least 50% of its total gross income (including, in the case of a member organization, the gross income of its corporate affiliates and subsidiaries controlled by the member organization.)"

New York Stock Exchange Rule 318.12, 2 CCH, New York Stock Exchange Guide Para. 2318 at p. 3075. The Commission did not object in principle to the "primary purpose requirement", although the Commission gave notice that it intended to review both the appropriateness of the requirement and the suggested standards for its determination. Securities Exchange Act Release No. 8849 (Mar. 26, 1970).

have contended the so-called "parent" test was necessary to permit adequate self-regulatory control.281/

Most regional exchanges have generally permitted some form of institutional membership.282/ The PBW Stock Exchange requires only that a member itself be engaged in the transaction of business as a broker or dealer in securities.283/ Since the PBW Stock Exchange does not require that a member be engaged in a public securities business, entities desiring to trade solely for their own account or the account of an affiliate are eligible.

The Pacific Coast Stock Exchange has required that all voting stockholders be active in the business of the member organization.284/ If a voting stockholder is a corporation, the rule "shall not be deemed to be met . . ., unless the principal business of that corporation and of its parents and subsidiaries and affiliated organizations, taken on a

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281/ For example, the President of the New York Stock Exchange stated: "With public ownership, the possibility will exist that persons or parties who are outside the control of the Exchange may own voting securities of a member corporation and, as a group or individually may control and dominate the affairs of the member corporation. From a self-regulatory standpoint, this situation cannot be solved by requiring the member organization to disclose the existence of the parent." Letter, dated October 31, 1969, from Robert W. Haack, President, New York Stock Exchange, to Irving M. Pollack, Director, Division of Trading and Markets, Securities and Exchange Commission. See also, Commission File No. 4-147, supra n. 84, Transcript at pp. 463-464, 1106.

282/ For a discussion of the growth of institutional membership from 1965 to 1970, see, Institutional Investor Study, supra n. 4 , pt. 4, at 2296-2310.

283/ PBW Stock Exchange Const., Art. XIV, Section 2, CCH, PBW Stock Exchange Guide Para. 1327, at p. 1093. The PBW Stock Exchange does, however, expressly prohibit membership for banks, their subsidiaries and investment trusts. PBW Stock Exchange Const., Art. XIV, Section 3, CCH, PBW Stock Exchange Guide Para. 1328, at p. 1093. But see Institutional Investor Study, supra n. 4, pt. 4, at p. 2308 n. 123.

284/ Pacific Coast Stock Exchange Const., Rule IX, Section 5 (a)(6), CCH, Pacific Coast Stock Exchange Guide Para. 4750 at pp. 3111-3112. Developments and changes in the PCSE rules since 1965 are discussed in the Institutional Investor Study, supra n. 4, pt. 4, at pp. 2308-2310.

consolidated basis, shall be that of a broker-dealer in securities."285/ The Board of Governors has discretion to waive this requirement, however.286/

Although the Boston Stock Exchange rules require that 80 percent of the outstanding voting stock of the member corporation be owned, and 60 percent of the total capital be contributed, by officers and directors of the corporation, the rules also provide that these requirements may be waived in appropriate instances.287/ The Boston Stock Exchange has terminated its policy of denying membership to affiliates of institutions generally, intending instead to consider such applications as they occur.288/

The Midwest Stock Exchange requires that a member corporation be primarily engaged in a general, public securities business. The "general" requirement is satisfied if (a) a "substantial portion" of the member's business is as a broker in exchange securities and if the balance is in other activities "traditionally associated" with the investment banking or broker-dealer business and is consistent with maintaining a flow of orders to the exchange (e.g., underwriting, retailing, investment advisory activities, OTC market-making), or (b) if the member's principal business is the performance of an approved floor function (e.g., as specialist, as floor broker or as registered floor trader). The "public" requirement is satisfied if at least 50 percent of all brokerage commissions, and 50 percent of gross income from the securities business, is derived from transactions for customers other than affiliates.289/

285/ Pacific Coast Stock Exchange Const., Rule IX, Section 5(a)(6). CCH, Pacific Coast Stock Exchange Guide Para. 4750 at pp. 3111-3112.

286/ Ibid.

287/ Boston Stock Exchange Rules, Ch. XXV, Section 1(a), CCH, Boston Stock Exchange Guide Para. 2225, at p. 2231.

288/ Letter, dated January 7, 1971, from James Dowd, President, Boston Stock Exchange, to Kenneth Rosenblum, Branch Chief, Office of Exchange Regulation, Division of Trading and Markets, Securities and Exchange Commission.

289/ Midwest Stock Exchange Const. Art. I, Rule 1(c), CCH, Midwest Stock Exchange Guide Para. 2021, at pp. 2021-2022.

The Commission does not believe that members of exchanges should be prohibited from affiliating with institutions. Indeed, we have already indicated that the continuing necessity for a "parent test" does not appear to be supported by reference to the purpose or intent of the Securities Exchange Act.290/ Contrary to the view espoused by the supporters of this requirement, it would appear that exchanges do have an adequate basis for self-regulatory control over the affairs of their members through direct control of their officers and directors and ultimate jurisdictional control over their parents in appropriate cases.291/ Furthermore, since the "parent test" restricts exchange membership on the basis of whether a firm's parent is engaged in a public securities business -- not whether the firm itself is so engaged -- it is inconsistent with the principle that any person prepared to engage in such a business (assuming he meets objective standards of financial responsibility and competence) should be permitted to do so.292/

290/ See, Policy Statement, supra n. 1, at pp. 21-22.

291/ See, e.g., New York Stock Exchange Const., Art. 1, Section 3(d); Art. IX, Sections 7(b)(1), 7(b)(3), 7(c); Art. XIV, Section 9, 2 CCH, New York Stock Exchange Guide, Para. 1003, at pp. 1051-52; Para. 1407, at pp. 1074-75; Para. 1659, at p. 1096.

292/ See infra at pp. 173-176. It is important to note here only that an exchange is an essential resource for those engaged in the business of executing securities transactions for public customers. "It is a basic rule of antitrust law that those who jointly control an essential resource must grant access to it, on equal and non-discriminatory terms, to all those in the trade." [Emphasis supplied.] See, Commission File No. 4-147, supra n. 84, written comment of the Antitrust Division, U.S. Department of Justice, "Antitrust Rules Governing Access to an Essential Facility," Appendix B, at p. B-1 and authorities cited therein. "The 'bottleneck' principle is clearly applicable to rules governing access by broker-dealers to the dominant exchange in the country." [Emphasis supplied.] This is not to say that an exchange may not limit the number of its memberships, see Silver v. New York Stock Exchange, 373 U.S. 341,350 (1962), just that entrance requirements must be fair and not discriminatory.

On the other hand, for reasons which are discussed in detail in the remainder of this section, the Commission does not believe that any entity should be permitted to join an exchange without accepting obligations and responsibilities to the exchange markets as public institutions.293/ Thus, any entity

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293/ See, infra., pp. 105-108, 126-133. Some commentators, particularly investment company managers, have asserted that the Commission has reversed its direction on the issue of membership for "recapture" purposes. See e.g., Commission File No. S7-452, supra n. 16, written comment of Keystone Custodian Funds, Inc. (Sept. 28, 1972), at pp. 1-4. The Commission has consistently taken the position that a mutual fund adviser has no duty to form or acquire a broker-dealer affiliate for the purpose of becoming a member of a stock exchange to execute the fund's portfolio transactions or to serve as vehicle through which brokerage commissions generated by the fund's portfolio transaction may be recaptured. See, e.g., Securities Exchange Act Release No. 8746 (Nov. 10, 1969); Memorandum of the Securities and Exchange Commission Objecting to Proposed Settlement in Kurach v. Weissman, 67 Civ. 9 (S.D.N.Y., 1969), at p. 13. Cf., Moses v. Burgin, 445 F. 2d 369, 374-375 (C.A. 1), certiorari denied sub nom Johnson v. Moses, 404 U.S. 994 (1971). When an investment manager or the fund's board of directors, however, determines that it is in the best interests of the fund to form such an affiliate, the Commission has taken the position that, except where the affiliate performs bona fide brokerage functions for the fund, any recaptured commissions or reciprocal business traceable to the fund's portfolio transactions must be used to benefit directly the fund's shareholders. See, Provident Management Corp., Securities Exchange Act Release No. 5115 (Dec. 1, 1970); Memorandum of the Securities and Exchange Commission as Amicus Curiae in Opposition to the Proposed Settlement in Gross v. Moses, 67 Civ. 4186 (S.D.N.Y., 1971), at p. 13 (as modified). It is difficult to see any inconsistency between the above position and Rule 19b-2, particularly when it is noted that the above position dealt with the conduct of fiduciaries in a given set of circumstances, cf., Securities Exchange Act Release No. 8239 (Jan. 26, 1969), at p. 1, whereas Rule 19b-2 deals with the proper membership structure of an emerging central market system. Nonetheless, even if the Commission were to have reversed past policy, it is well

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wishing to join or remain a member of an exchange must be predominantly engaged in the business of being a broker-dealer with public, unaffiliated customers and no entity or individual can be permitted to utilize an exchange membership solely for its own private trading purposes.294/ Rule 19b-2 is designed to effectuate these principles.295/

B. Institutional Trading and the Commission Rate Structure

The desire for institutional membership on national securities exchanges has been closely interrelated to the level and structure of exchange commission rates. The Institutional Investor Study transmittal letter stated:

> "The Commission expects that its recent decision on competitive rates on large orders

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293/ (Continued)

settled that "administrative authorities must be permitted, consistently with the obligation of due process, to adapt their rules and policies to the demands of changing circumstances." Permian Base Area Rate Cases, 390 U.S. 747, 784 (1968). Cf. American Trucking Association, Inc. v. United States, 344 U.S. 298, 313-314 (1953); Federal Communications Commission v. WOKO, Inc. 329 U.S. 223, 228 (1946); Shawmut Association v. Securities and Exchange Commission, 146 F.2d 791, 796-797 (C.A. 1, 1945).

294/ "[A] seat on an exchange should not represent a monopoly on its use or economic advantages to exchange members which are disproportionate to the value of the functions they perform for others." House Study, supra n. 4, at p. 123.

295/ See infra. pp. 135-166.

> will have the effect of reducing artificial inducements to the combination of management and brokerage functions, and that this in turn will tend to reduce but not eliminate economic pressures toward institutional membership on stock exchanges. Further actions to increase the fraction of institutional transactions subject to competitive rates, of course, could be expected to further reduce such pressures. The Commission realizes, however, that issues relating to institutional membership are at least partially separable from questions regarding the level and structure of brokerage commissions and would not be disposed of entirely even by fully competitive rates on all securities transactions."296/

The transmittal letter also noted that "practices such as the fixed noncompetitive commission rates . . . have tended to work against the development of a central market system. . . ."297/ More recently, in its February 2, 1972 Statement on the Future Structure of the Securities Markets, the Commission restated unequivocally that "[f]ixed minimum commissions, at least on institutional size orders, may well make it very difficult, if not impossible, to create the central market system. . ."298/

296/ Institutional Investor Study, supra n. 4 , pt. 8, at pp. XX-XXI.

297/ Id., at pp. VII, XX-XXI.

298/ See Policy Statement, supra n. 1 . See also, 1972 House Hearings, supra n. 110, pt. 6, at pp. 2946-2947, 4294 - 4295, and Hearings on S. 3169 before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 92d Cong., 2d Sess., pt. 1, at pp. 7-8 (1972).

When the Commission began its inquiry into commission rate issues, it became immediately apparent that the phenomenon of institutional growth was having a far-reaching impact on the securities industry.299/ The rigid commission rate structure had been unresponsive to the growth of this newly important category of customer. The commission rate was based on geometric progression: a commission on a 10,000 share transactions was 100 times the commission on a 100 share transaction; the commission on 100,000 share transaction was 1,000 times the commission on a 100 share transaction. Nevertheless, the average cost of handling a 1,000 share, a 10,000 share and a 100,000 share order of a $40 stock was estimated at approximately 6, 42 and 377 times as great as the cost of handling a 100 share order300/ (although this estimation did not reflect the additional skill, risk and responsibility that such larger orders entail).

Informal interviews by the staff indicated that, not surprisingly, on institutional size orders, "give-up"301/ practices had proliferated to a point where the fixed minimum commission rate existed in form only. On January 26, 1968 the Commission announced it was considering a proposed rule under the Securities Exchange Act, Rule 10b-10, which would have prohibited investment company managers from directing the brokers executing portfolio transactions for the investment companies to give-up part of their compensation to other brokers unless the benefits were to

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299/ Institutional volume as a percent of total public volume had increased from 25.4% in March 1956 to 42.9% in 1966.

300/ Institutional Investor Study, supra n.4 , pt. 4, at p. 2172.

301/ A "give-up" was a payment, by the broker executing a securities transaction to other brokers and dealers in securities, of a part of the minimum commission the executing broker is required to charge his customers by exchange rule. Under the rules of the stock exchanges as they existed in early 1968, the payment could have been made on the executing broker's own initiative and for his own purposes, or it might have been directed by the customer or its institutional manager. The recipient of a "give-up" check might have had nothing whatsoever to do with the transaction for which the commission was charged and, in fact, may not even have known of the transaction or where or when it was executed. Give-ups were widely used in connection with mutual fund portfolio transactions: managers of mutual funds directed give-ups, for the most part to brokers and dealers in securities who had sold fund shares, in order to motivate, or reward, such sales efforts.

accrue to the investment company and its shareholders.302/ This rule assumed that the prevalent give-up practices would continue and dealt only with the conduct of fiduciaries in that context.

Shortly thereafter the Commission announced public hearings 303/ to consider whether any changes should be made in the rules of the securities exchanges respecting commission charges made thereon. The Commission's public investigation revealed that give-up practices were indeed prevalent and that exchanges were competing with one another to liberalize rules governing give-up practices in order to attract volume.304/ Management companies were insisting on,305/ and brokerage firms cooperated

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302/ Securities Exchange Act Release No. 8329 (Jan. 26, 1968). The release also announced proposals submitted to the Commission by the New York Stock Exchange which contemplated (1) a volume discount; (2) access to the exchange market by qualified nonmember broker-dealers; (3) recognition of limited customer-directed give-ups to both members and nonmembers of the NYSE; (4) a prohibition of institutional recapture arrangements; and (5) a requirement that regional exchanges impose similar restrictions.

303/ Securities Exchange Act Release No. 8324 (May 28, 1968). That release also announced that the Commission had sent a letter to the New York Stock Exchange pursuant to Section 19(b) of the Securities Exchange Act) requesting it to adopt a revised rate schedule which would provide for a volume discount on round-lots above 400 shares or competitive commission rates for orders involving more than $50,000. Similar letters were also written to the other registered exchanges requesting that the same changes be considered.

304/ For a discussion of give-up practices on the various national exchanges, see Commission File No. 4-144, supra n. 65, Transcript at pp. 4900-4935, 4990-4998 for New York Stock Exchange members; pp. 487, 574, 630, 899, 1166 for American Stock Exchange members; pp. 643, 867-903 for Boston Stock Exchange members; 933-1015, 1019, 1030, 1033-36 for PBW Stock Exchange members; 543, 916-962, 1181 for Midwest Stock Exchange and Detroit Stock Exchange members; and 289-295, 355, 482-484 for Pacific Coast Stock Exchange members. Data collected on the amounts given-up and the extent of these practices may be found in Institutional Investor Study, supra n. 4, pt. 4, at pp. 2182-2298; Give-up rules and practices in effect on the various exchanges are also discussed in Securities and Exchange Commission, Report on the Public Policy Implications of Investment Company Growth, H. Rep. No. 2337, 89th Cong., 2d Sess., at pp. 167-181 (1966); 2 Special Study supra, n.39 , at pp. 859, 864.

305/ See, e.g., Commission File No. 4-144, supra n. 65, Transcript at pp. 1733-1738, 1850-1856, 2280-2282.

in providing, give-ups ranging from 50% to 90% of each commission dollar charged.306/ Besides the pervasive give-up practices, "service competition" among brokers was extensive.307/ The general trading practices among institutions and their brokers revealed, in short, that brokers recognized the "fat" in the institutional commission dollar and were prepared to offer either valuable services in return or to write out give-up checks to other broker-dealers as directed by the institution.

In response to the Commission's letter,308/ the New York Stock Exchange proposed, on August 8, 1968, an interim commission rate incorporating a volume discount for orders in excess of 1,000 shares and a prohibition of customer-directed give-ups.309/ In light of the information collected up to that point in the hearings, the Commission accepted the NYSE revisions, which became effective on December 5, 1968.310/ Under

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306/ See, e.g., id., Transcript at pp. 167-192, 274, 283-286, 696.

307/ The Commission found that members were offering direct wire connections to institutions, id., at pp. 80, 112-113; portfolio valuations twice daily, id. at pp. 86-87; special services, id., at pp. 113-114; preparation and distribution of advertising literature, id., at pp. 106-109; compensating balances at banks, id., at pp. 90, 109-110; and purchasing insurance products from active insurance company customers, id., at p. 92. It is possible, of course, that the service competition produced a distension of product parameters offered by the brokerage firms, i.e. services which might not have been desirable if institutional size orders had been negotiable. See Baxter, NYSE Fixed Commission Rates: A Private Cartel Goes Public, 22 Stan. L. Rev. 676, 677-78 (1970). For a general description of the business relationships between institutions and broker-dealers, see Institutional Investor Study, supra n.4 , pt. 4, at pp. 2263-2265, 2273-2274, 2277-2286.

308/ Securities Exchange Act Release No. 8324 (May 28, 1968).

309/ Securities Exchange Act release No. 8399 (Sept. 4, 1968).

310/ Ibid. The hearings were to continue, however, focusing in the main on such issues as exchange membership for financial institutions, restrictions on access by exchange members to the third market and competition among exchanges and between exchanges and other markets. See Securities Exchange Act Release No. 8432 (Oct. 21, 1968) and Securities Exchange Act Release No. 8791 (Dec. 31, 1969).

the revised schedule, the rates in effect on large transactions (over 1,000 shares) were reduced by approximately 40%.311/ Moreover, where an order to a single customer would involve more than $100,000 in commission charges, figured by the minimum schedule, the amount over $100,000 would be negotiable.312/

After the prohibition of customer directed give-ups, institutional managers wanting to distribute commission dollars in return for fund sales, research or other services gave orders directly to the broker-dealer they wanted to compensate. Thus, broker-dealers that had formerly received give-up checks from the lead or executing brokers now received orders directly from the institution and might execute the order itself or forward the order to a correspondent broker for execution and clearance.313/ Two regional exchanges split their seats just prior to December 5, 1968, in anticipation of the give-up prohibition, increasing the available membership by 100 percent and reducing the cost of membership by one-half.314/

It was clear to the Commission that the distortions and artificial industry infra-structure created to facilitate utilization of commission dollars would continue to exist and grow unless further steps were taken to eliminate the remaining excess in commission charges on large orders.

311/ Institutional Investor Study, supra n. 4 , pt. 4, at p. 2200.

312/ For example, under the rate prior to December 5, 1968, an order for 300,000 shares of a $40 stock would have involved a minimum commission of $117,000. After December 5, 1968, the amount over $100,000 was negotiable.

313/ For a graphic description of the arrangements which began after the give-up prohibition, see Institutional Investor Study, supra n. 4 , pt. 4 at pp. 2205-2206.

314/ Ibid.

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

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ROSALIND FOGEL and GERALD FOGEL, :

Plaintiffs, :

-against- : 68 CIVIL 2855

GEORGE A. CHESTNUTT, et al., :

Defendants. :

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Deposition of FRANK G. FOWLER, JR., a witness, taken by plaintiffs pursuant to stipulation of the parties, at the offices of Messrs. Pomerantz Levy Haudek & Block, 295 Madison Avenue, New York, N. Y. 10017, on February 5, 1973, at 10:30 a.m., before Leon Zuck, a Certified Shorthand Reporter and Notary Public of the State of New York.

A Being what we were, it didn't have any merit under the present laws and regulations.

Q Mr. Lee told you that recapture was impossible, is that correct?

A It didn't apply to us. It would be all right for a load fund.

Q But for a no-load fund to recapture, it didn't apply?

A Along those lines.

Q Mr. Lee told you that?

A I believe so.

Q Did you ever inquire from anyone else aside from Mr. Lee whether it was possible?

A No.

Q Did you ever consider the possibility of doing that?

A Not really.

Q Didn't you think that perhaps Mr. Lee would have a conflict of interest since he represented the management company?

A No, not in this instance.

Q Wasn't it in the management company's interest to see that brokerage commissions went to brokers who assisted in the sale of fund shares?

Q You are aware, sir, that there were brokers who assisted in the sale of fund shares?

A Yes. Without compensation directly.

Q They got indirect compensation, did they not?

A Only in that if their prices were equivalent, the same and the same execution and the speed as anyone else, they might have gotten a little bit of consideration over another broker quoting the same thing.

Q How about, sir, before December of 1968 when they could get give-ups, didn't they get checks in the mail from the--from brokers who executed fund transactions?

A Executed fund transactions?

Q Portfolio transactions for the Fund.

A Not shares. You are--

Q Yes.

A Our shares?

Q Your portfolio shares.

A Did they not--

Q Didn't they get give-ups before December 1968?

A It's possible they did.

Q Is it possible, sir, or do you know it as a fact?

A I don't know it as a fact.

Q Didn't it appear in the prospectuses of the Fund?

A Yes.

Q That these brokers got give-ups?

A Right.

Q Do you still not know it as a fact?

A Yes. Now that it was in the prospectus.

Q So you knew before December of 1968 that the Fund was directing give-ups to brokers who assisted in the sale of fund shares, did you not?

A Yes. I would say yes.

Q Didn't you consider this to be an improper practice?

A No. This has been customary, I believe, in other transactions, other than our fund.

Q Because it was customary, sir, you considered it to be proper?

A Yes.

Q Did you ever consider the possibility that brokers who directed give-ups would not give you the best price or the best execution?

A Did we ever consider it?

Q Yes.

A Well, I'm sure that our adviser did and he wouldn't go into it if he wasn't getting the best price. He is a pretty, I think a very astute investor. He is not

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs,

-against- 68 Civ. 2855

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WALTER K. GREENE, RICHARD M. RADCLIFFE, STANLEY L. SAGAL, FRANCIS L. VELDER, AMERICAN INVESTORS CORPORATION, AMERICAN INVESTORS FUND, INC., CHESTNUTT CORP.,

Defendants.

- x

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WYATT, District Judge,

This is the decision after trial without a jury on the issue of liability alone. There will be judgment for defendants on this issue.

Plaintiffs are and have been since January 11, 1963 holders of record of shares of capital stock of American Investors Fund, Inc. (Fund), a New York corporation. Fund is a diversified open-end management investment company registered as such under the Investment Company Act of 1940 (15 U.S.C. § 80a-1 and following ("the 1940 Act"); see §§ 80a-3, 80a-4, 80a-5, 80a-8). Fund is one of the many companies usually called a "mutual fund". Fund does not charge a "sales load" (commission) on its shares sold (15 U.S.C. §§ 80a-2(35), 80a-10(d)).

Fund was organized in 1957 and had for some time as its investment adviser, American Investors Corporation. Since July 19, 1966, the investment adviser of Fund has been Chestnutt Corporation (Adviser), a Connecticut corporation which acquired all the assets of American Investors Corporation. For simplicity, the term "Adviser" will usually be meant to include American Investors Corporation. The Adviser manages Fund and acts under an investment advisory contract between it and Fund.

George A. Chestnutt, Jr. (George), for whom the Adviser is named, is president and principal stockholder (47%) of the Adviser and president and a director of Fund. He has been the chief figure in Fund and in the Adviser.

The action was commenced on July 11, 1968, and is a derivative one on behalf of Fund (a nominal defendant). The action is also said to be brought "representatively" for all other "shareholders of the [illegible]larly situated"; what this means is not clear.

The named defendants are the Adviser, its predecessor (American Investors Corporation) and the seven directors of Fund when the action was commenced. Four of these individual defendants were served and defended: George, Currier, Greene, and Sabel. Currier is a director of Fund and owns voting common stock (2%) of the Adviser; he is a corporate executive in the woman's wear field. Greene is vice president and a director of Fund and vice president and a small stockholder (0.4%) of the Adviser. Sabel is a lawyer and a director of Fund; before his retirement in 1971, Sabel was senior vice president and secretary of Fund and was also vice president, secretary, director, and substantial stockholder (16%) of the Adviser (he may still be a substantial stockholder of the Adviser).

The complaint named three other directors of Fund who were not served and did not appear: Fowler, Radcliffe, and Veeder.

Jury trial was demanded by plaintiffs.

The complaint in one count avers a claim that the Adviser and the individual defendants enriched themselves at the expense of Fund by the use of "reciprocal brokerage" and "give ups". Specifically, the charge is that defendants

violated the 1940 Act "by failing to recapture brokerage commissions for the Fund" (Post-Trial memo for plaintiffs, p.2).

The complaint avers that this Court has jurisdiction under the 1940 Act and also under the Investment Advisers Act of 1940 (15 U.S.C. § 80b-1 and following) and the Securities Exchange Act of 1934 (15 U.S.C. § 78a and following; "the 1934 Act"). Plaintiffs appear to rely solely on the 1940 Act.

By order filed June 29, 1973, it was directed that "the issue of liability will be tried separately and before the issue of damages". The Court was advised at that time that the action would be tried without a jury.

A pretrial order signed September 4, 1973 (but for some reason not filed until October 4, 1973), noted that the right to a jury trial had been waived by "both parties".

Without opposition by defendants, the plaintiffs were permitted to serve and file a supplemental complaint, the principal (if not only) function of which was to bring the complaint down to date. The supplemental complaint was filed on August 24, 1973 (a copy with verification added was filed on August 30, 1973). No order was made that defendants plead to the supplemental complaint (Fed. R. Civ. P. 15(d)); note was taken of this situation at trial and new paragraphs of the supplemental complaint were "deemed denied" (SM 6; SM references are to pages of the stenographic minutes).

It is difficult to tell the time period for which

this action is brought. Based on the averments in paragraphs 21(a) and 23(a) of the supplemental complaint, it would appear to be from January 1, 1965 down to date. For reasons which will appear, however, the claim as to give-ups must end on December 5, 1968, and the claim as to reciprocal brokerage must end on July 15, 1973. Counsel for plaintiffs insist (Tr 65) that membership on two regional exchanges would have yielded preferences thereafter, but, as will appear, SEC Rule 19b-2 prohibited this, effective March 15, 1973.

1.

Since 1964, Fund has had either eight or seven directors.

With respect to directors, the parties have used the terms 'affiliated' and "unaffiliated" but have not defined these terms. The 1940 Act uses the expression "interested persons" in referring to directors (15 U.S.C. § 80a-10(a)) which is elsewhere defined to include an "affiliated person" (15 U.S.C. § 80a-2(a)(19)(A)(i)) which latter term is elsewhere defined (15 U.S.C. § 80a-2(a)(3)). For purposes of this action, an affiliated director may be considered as one connected with or having an interest in Adviser, as opposed to an independent director, having no connection with or interest in Adviser.

Since 1964, Fund has had either three independent directors out of seven or four independent directors out of eight. Fund has had four affiliated directors. Currier is counted as an affiliated director because, while not employed by Adviser, he has owned 2% of the voting common stock of

Adviser.

Fund and Adviser had the same counsel. Sabel and his firm were counsel to both until 1971 or 1972. Clendon H. Lee, whose wife has been for a long time the owner of a small amount (1%)of the voting common stock of Adviser, became special counsel to Fund in 1965 and his law firm has acted as counsel to Fund since at least April 28, 1972.

Under the investment advisory contract, Adviser manages and advises Fund, furnishes all offices to Fund, pays all officers and employees of Fund, and in short does everything for Fund.

Fund pays nothing for expenses except fees to directors.

Under the investment advisory contract, Fund pays the Adviser for its services on an annual rate of a percentage of the net asset value of Fund. These payments have been substantial, ranging from $187,000 in 1964 to $1,557,000 in 1969.

2.

The charges in this action had their origin in the size of the transactions made on stock exchanges by mutual funds and other institutions. As these transactions developed, they involved buying and selling large blocks of shares and at the rates fixed by the exchanges (no quantity discounts) the brokerage commissions became so great that members of the exchanges could execute fund transactions at a cost of only a

small part of the commissions which had to be charged. Naturally, exchange members were eager for mutual fund business and would have been willing to rebate part of their commissions to the customer mutual funds but were prevented by exchange rules from doing so.

In this climate, brokers had a strong motive to give help to managers of mutual funds by (a) selling shares of the fund or (b) supplying the manager with investment research and advice, or (c) doing both. The manager of the mutual fund would then allocate part of its brokerage business to such helpful brokers, and could see that the commissions earned by such helpful brokers bore a relation to the value of the sales efforts and of the research and advice. These allocated orders were known as "reciprocals".

For some funds, especially big funds, it became undesirable to allocate brokerage orders on the basis of the value of non-brokerage services rendered. This was principally because sales of the mutual fund shares were made by many independent brokers or dealers; to send brokerage transactions through so many brokers would not be prudent from a management standpoint, this for many good reasons.

To meet this situation, the brokers and mutual fund managers worked out the technique of the 'give-up'.

The 'give-up' technique was that the broker who executed the fund transaction surrendered a part of his commission to other brokers designated by the customer fund, acting of necessity through the fund manager. In this way,

the fund manager could spread the commissions on fund executions among a number of brokers, who, although they had nothing to do with execution of the transaction, had been otherwise helpful in selling fund shares or in giving investment advice or both.

Brokers executing transactions for mutual funds were willing to give up as much as 75% or more of their commissions.

As might be expected, the Securities and Exchange Commission (SEC) became concerned with the influence of fund and other institutional transactions on the structure of the market for securities, as well as with the fixed rates (without quantity discounts) charged under exchange rules. It was this last feature which had resulted in the development of reciprocals and give-ups.

The "give-up" technique was not without its limits. Because of a rule of the New York Stock Exchange (NYSE), commissions on transaction there could only be given up to other members of that exchange. The regional exchanges, as a way of competing with NYSE, were less strict. Nearly all the regional exchanges permitted commissions to be given up to non-members provided they were members of National Association of Securities Dealers, Inc. (NASD).

NASD is the only "national securities association" registered with the SEC under Section 15A of the 1934 Act (15 U.S.C.S 780-3; the Maloney Act (added in 1938)), the

purpose of which was to establish supervised self-regulation of over the-counter brokers and dealers. NASD has rule-making power.

The availability of give-ups posed a dilemma for fund managers. The business was that of the funds; the fund was the customer. But exchange rules prevented any rebate on the fixed commissions to the customer. Rather than leave all the commissions with the executing brokers, the fund manager directed give-ups to those brokers who sold fund shares. True, as plaintiffs argue, this benefited the fund manager because it rewarded brokers who sold fund shares, who thus increased the assets of the fund, and who thus enabled advisory fees to increase. But it did no harm to the fund because (by definition) the fund could in no event secure a rebate. In point of fact, there was some benefit to the fund stockholders from the increase in fund assets by sale of more shares; advisory fees usually, if not always, go down on a sliding scale of ascending asset value (such was the case with Fund here).

Some fund managers, however, sought to secure a benefit to their funds by recapturing for them a part of the excess commissions available as give-ups. This was done beginning in 1965 by use of a broker-dealer affiliate who was a member of NASD, as, for example, the underwriter who soldshares of a 'load' fund on a commission basis and whose qualification to be a member of NASD was clear. In at least a few instances, the fund managers created a broker-dealer

subsidiary which became a member of a regional exchange. By these means, some of the commissions on portfolio transactions were used to reduce the advisory fees of the fund managers.

The concern of the SEC with fixed commission rates (without quantity discounts on large transactions) included a concern with the give-up technique. These concerns in 1968 led to discussions between the SEC and NYSE; as a result of pressure from the SEC, give-ups on NYSE were prohibited by its rules after December 5, 1968. In response to the same pressure, all the regional exchanges prohibited give-ups at the same time.

Reciprocals could not be used after July 15, 1973, because a Rule of NASD effective that date prohibited them. (The Rule was adopted by NASD after the SEC had publicly stated that "reciprocal practices must be terminated" for a number of reasons given in the statement: see SEC Policy Statement, February 4, 1972.)

In its continuing study of the securities business, the SEC took note of the use by some fund managers of membership in regional exchanges as a means of securing give-ups or otherwise to recapture commissions. The SEC found this to be against the public interest and on this account and for other reasons, effective March 15, 1973, the SEC adopted Rule 19b-2 under the 1934 Act. This Rule required that each member of a national securities exchange must have "as the principal purpose of its membership the conduct of a public securities

business" (emphasis supplied), which was defined to mean that 80% in value of its exchange transactions had to be for persons not affiliated. The effect of this Rule was to make it impossible for investment companies to recapture any part of their commissions through the use of broker affiliates (unless such affiliate did 80% of its business with persons independent of the investment company, that is, was truly a "public" broker).

The SEC took note at the time (Release No. 9950, January 16, 1973, section VII (A)):

> "On the regional exchanges many subsidiaries of investment managers and insurance companies have purchased seats to trade for the account of the affiliated 'parent' or to be used for 'recapture' of commission dollars for that parent."

One of the principal reasons given for the adoption of Rule 19b-2 was a finding by the SEC that "membership (in an exchange) utilized primarily . . . for the purpose of . . . recapturing commissions charged on exchange securities transactions, directly or indirectly, is inimical to the protection of investors, fair dealing in securities traded in upon such exchanges, the fair administration of such exchanges and the interests of the public investors we are mandated to protect in the development of a central market system for listed securities." SEC Release No. 9950, January 16, 1973, Introduction.

It may be mentioned that Rule 19b-2 has been attacked by a regional exchange: its appeal to a court was dismissed for

lack of jurisdiction, without reaching the merits. PBW Stock Exchange, Inc. v. SEC, 485 F.2d 718 (3d Cir. 1973), cert. denied __ U.S. ___ (1974).

3.

The Adviser and those interested in it - chiefly George - managed and controlled the Fund. If there were a conflict in interest between the Fund and the Adviser, the economic interest of the chief personalities would be with Adviser. In a general sense, however, what was good for the Fund was good for the Adviser, that is, the more successful and the larger the Fund became, the greater would be the advisory fee to Adviser.

In the matter of reciprocals and give-ups, there is no question but that the Adviser, acting for Fund, directed reciprocals and give-ups to brokers who sold Fund shares or who gave research material to the Adviser or both. To what extent this was done is difficult to say. According to the records, all brokerage commissions were so treated. For example, in the prospectus of Fund dated May 1, 1968 (Ex. [illegible]) it was stated that all brokerage commissions were paid either to "brokers who provided helpful information" or to brokers "in connection with the sale of Fund shares". In his testimony, George suggested that records for the SEC required such allocation to be made. In any event, it is clear that the Adviser directed substantial amounts of reciprocals and give-ups. The Adviser used give-ups to reward brokers who sold Fund shares, seeing

to it that they got in earned commissions or give-ups at least 2% and usually more of the amount of Fund shares sold by them. Discovery into the specific amounts of give-ups was not permitted (because related to liability) but it is known that there were $326,120 in give-ups in 1967 and $633,095 in 1968. Nearly all the transactions for Fund were on NYSE but a "small percentage" was on regional exchanges (SM 266). It is known that there were $205,000 in give-ups on regional exchanges between October 1966 and November 1968.

The use of reciprocals and give-ups was fully disclosed in the prospectuses of Fund.

Mutual funds may sell their shares in a number of different ways. Some use an underwriter who buys at wholesale from the fund and sells at retail either through an internal sales force or through independent broker-dealers who are paid a commission. Others, the no-load funds - such as Fund here - sell direct to investors or through independent broker-dealers who are not paid a commission. The use of give-ups supplied a motive to brokers for selling Fund shares; since no commission was paid on such sales, give-ups (or reciprocals) were the only reward to the brokers.

The use of give-ups and reciprocals did benefit the Advisor. Their use also benefited the Fund and its stockholders because the larger the Fund, the smaller the expenses of Fund would be per dollar of invested assets.

The use of reciprocals and give-ups did not cause any

damage to Fund unless plaintiffs can establish that they, or a part of them, could have been recovered for the benefit of Fund.

4.

Under the theory of the case for plaintiffs, it is necessary for them to show that Fund or Adviser could have formed a subsidiary which could have properly become a member of NASD. While this is a hypothetical matter, it can be determined because the qualifications for NASD membership are in evidence (Ex. 21).

Counsel for plaintiffs insist that a subsidiary of Fund or Adviser could be a "broker" and be eligible for NASD membership; that obtaining membership would be "routine". Counsel for plaintiffs do not argue that such a subsidiary should do business with the public in competition with other brokers nor that the subsidiary should execute any transactions for Fund. The argument is that the subsidiary could secure NASD membership solely to qualify for give-ups and other preferences on regional exchanges. See Post-Trial Memorandum for plaintiffs, pp. 19-41

Counsel for defendants ignore this issue and offer no help to the Court. It remains a responsibility of the Court to reach a just determination of the issue.

It is concluded that such a specially created subsidiary of Fund or Adviser would not be eligible for membership in NASD.

The qualifications for NASD membership are in relevant part as follows (Ex. 21, p.1049):

> "Any broker or dealer authorized to transact and whose regular course of business consists in actually transacting any branch of the investment banking or securities business in the United States, under the laws of any State and/or the laws of the United States, shall be eligible to membership in the Corporation . . . ."

The definition of a "broker" is as follows (Ex.21,p.1059):

> "The term 'broker' means any individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization or other legal entity engaged in the business of effecting transactions in securities for the account of others, but does not include a bank."

This definition is in substance that contained in the 1934 Act 915 U.S.C. § 78c(a)(4)).

A subsidiary such as plaintiffs suggest would not be "transacting any branch of the . . . securities business". It would not be "transacting" any "business"; it would simply be a device for securing a preference in commission rates for one investor over other investors. Nor would it be a "broker" since it would not be "effecting transactions in securities for the account of others". It would not be "effecting transactions in securities"; it would simply be receiving preferences. Nor would it be acting for the account of "others" (plural); the suggestion is that it act for Fund alone to qualify for preferences.

Neither the 1934 Act nor the NASD qualifications contemplate that such a device could be considered a "broker".

Counsel for the plaintiffs understandably rely on the testimony by deposition of general counsel to NASD (Ex.20). This testimony is puzzling: it is not clear. At one point, the witness states that there is a "free entry policy" because "Anyone can become a broker-dealer under the 1934 Act who meets the statutory requirements". This Court agrees. If the witness means that such a subsidiary as plaintiffs suggest would be eligible for NASD, I disagree. True, had there been an application, NASD might have accepted the application. This would not have established eligibility but would have been an administrative failure of NASD. In any event, civil liability cannot be imposed for failure of defendants to do what it would have been deceptive and improper for them to do.

5.

The principle is accepted that defendants were under a duty by all proper means to secure for Fund the return of excess brokerage commissions. It is not shown that defendants could have properly secured any return for Fund.

Counsel for plaintiffs ably argue that there were three ways of doing this: (a) give-ups through the PSW Stock Exchange, (b) give-ups and discounts through the Pacific Coast Stock Exchange, and (c) tender offer fees. See Post-Trial Memorandum, pp. 24-30 All three depended, however, on membership in NASD and, as explained above, the suggested subsidiary would not be eligible for NASD membership.

In addition, counsel for plaintiffs argue (Post-Trial

Memorandum, pp. 30-33) that there were advantages to membership by a new subsidiary in the PBW Stock Exchange. It is accepted that membership in PBW did not require membership in NASD (Tr. 57-58).

These advantages, if any, were obtainable only for the period prior to March 15, 1973, when Rule 19b-2 became effective. But to secure such advantages (assuming that there were some) would require defendants to pretend that the new subsidiary was a broker, when in fact it was not, for the purpose of securing a preference over other investors by recapturing a part of the fixed commissions. While it may have been theoretically possible for PBW and the defendants, in collusion and for the selfish purposes of each, to accomplish such a result, it would have been contrary to public policy. The SEC found, as already noted, that to use membership in an exchange "for the purpose of . . . recapturing commissions . . . is inimical to . . . fair dealing in securities traded in upon such exchanges . . .".

Civil liability can scarcely be imposed for failing to do what it would have been contary to public policy for the defendants to do.

6.

Counsel for plaintiffs, with some reason, rely on Moses v. Burgin, 445 F.2d 369 (1st Cir.), cert. den. 404 U.S. 994 (1971), and argue (Post-Trial Memorandum p.2) that "the issues and facts" in the case at bar are "virtually identical

to the issues and facts' in Moses. The argument cannot be accepted.

Whether Moses was rightly decided is subject to some doubt and such doubt is permissible since the decision is not binding in this Circuit. It should be noted that Moses was decided in June, 1971, some time before the finding by the SEC that use of exchange memberships to recapture commissions was against public policy and before the adoption of Rule 19b-2. The Moses decision has not been applied in any action in this Circuit but has been discussed by Judge Curfein in Weiss v. Chalker, 55 F.R.D. 168 (S.D.N.Y. 1972) and 59 F.R.D. 533 (S.D.N.Y. 1973). There is nothing in Judge Curfein's discussion which would suggest liability in the case at bar.

For present purposes, it is assumed that Moses reached the right result. It is not applicable here, however, because, while the situation in Moses is superficially similar to that in the case at bar, the two situations on study are seen to be clearly distinguishable.

The fund in Moses was not (as here) a no load fund. On the contrary it sold its shares to an underwriter (Crosby) which was a subsidiary of the adviser and which resold the shares through independent brokers and dealers who in turn resold to investor customers who paid a commission on the purchase. Crosby was a member of NASD.

Crosby was not only a member of NASD before the Moses litigation began but Crosby appears properly to have qualified

for such membership. Crosby's qualification for NASD membership was accepted without question by all parties in Moses and by the Court of Appeals (see 445 F.2d at 375). While Crosby was not a "broker" and did not deal with the general public, it was a "dealer" because it bought the fund shares for its own account and resold them "to independent broker-dealers" (445 F.2d at 371). This fits the definition of "dealer" used by NASD (Ex. 21, p.1059).

Counsel for plaintiffs in Moses are counsel for plaintiffs here. In Moses they argued that the fund could have recovered ("recaptured") part of the commissions paid on fund portfolio transactions,

(a) by creation of a broker affiliate, or

(b) by channeling give-ups to Crosby (a member of NASD) and having Crosby credit the fund on its advisory fee.

The District Court ruled (316 F.Supp. 31) that neither method of recapture was available.

The Court of Appeals ruled that there was no duty to recapture by creating a broker affiliate but that there was a duty to channel give-ups to Crosby.

The holding in Moses was that if recovery ("recapture") of give-ups was "freely available" to the fund there, its directors had a duty to recover them for the fund (445 F.2d at 374). The Court of Appeals found that some of the regional exchanges "permitted members of the National Association of Securities Dealers (NASD) who were not exchange members . . . to

receive customer directed give-ups. Crosby was a member of NASD." (445 F.2d at 375)

It is not clear on what basis the Court in Moses held liable the adviser and the affiliated directors. At some points, it appears to us because there was a "failure to disclose" to the unaffiliated directors "the possibility of recapture through Crosby's NASD membership (445 F.2d at 377, 383-84). But whatever the basis of liability may be, it must rest on a conclusion by the Court of Appeals that recapture was "freely available" in Moses. The conclusion is never expressly stated but it is implicit in the reasoning (see, for example, 445 F.2d at 384-85).

For the reasons already given, recapture was not "freely available" in the case at bar. Thus, the decision in Moses v. Burgin has no application.

The Clerk is directed to enter judgment in favor of defendants, dismissing the action on the merits.

SO ORDERED.

Dated: New York, New York
October 29,1974

INZER B. WYATT
United States District Judge

U.S. DISTRICT COURT
FILED
NOV 6 1974
S.D. OF N.Y.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

ROSALIND FOGEL and GERALD FOGEL : 68 Civil 2855 (IBW)

Plaintiffs : JUDGMENT

-against-

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREEN, RICHARD W. RADCLIFFE, STANLEY L. SABEL, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, AMERICAN INVESTORS FUND, INC., CHESTNUTT CORP.

Defendants.

The above entitled action having been brought on regularly for trial before the Honorable Inzer B. Wyatt, United States District Judge, on September 4,5,6,10, and 11, and October 4, 1973, on the issue of liability, and at the conclusion of the evidence, the Court having reserved decision, and the Court thereafter on October 29, 1974, having handed down its opinion in favor of the defendants, it is,

ORDERED, ADJUDGED and DECREED: That defendants GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREENE, RICHARD W. RADCLIFFE, STANLEY L. SABEL, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, AMERICAN INVESTORS FUND, INC., CHESTNUTT CORP., have judgment against the plaintiffs ROSALIND FOGEL and GERALD FOGEL, dismissing the action on the merits.

Dated: New York, N.Y.
November 6, 1974

Raymond F. Burghardt
Clerk

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs,

-against-

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREEN, RICHARD W. RADCLIFFE, STANLEY L. SABEL, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, AMERICAN INVESTORS FUND, INC. and CHESTNUTT CORP.,

Defendants.

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68 Civ. 2855 (IBW)

NOTICE OF APPEAL

S I R S :

Notice is hereby given that plaintiffs Rosalind Fogel and Gerald Fogel hereby appeal to the United States Court of Appeals for the Second Circuit from a judgment entered on November 6, 1974 against plaintiffs dismissing this action on the merits.

Dated: New York, New York
December 2, 1974

Yours, etc.,

Pomerantz Levy Haudek & Block

By Daniel Krasner
Attorneys for Plaintiffs
Rosalind Fogel and Gerald Fogel
295 Madison Avenue
New York, N.Y. 10017
Tel. No. 212-532-4800

TO:

Clerk,
United States District Court
for the Southern District of New York
United States Courthouse
Foley Square
New York, N.Y. 10007

ROGERS HOGE & HILLS, ESQS.
Attorneys for Defendants
Chestnutt, Jr., Currier,
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and American Investors Corp.
90 Park Avenue
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Attorneys for Defendant
American Investors Fund
200 Park Avenue
New York, N.Y. 10017

ONE (1) COPY
Service of ~~three (3) copies~~ of the within
APPENDIX is hereby admitted
this 8 day of APRIL, 1975
Rogers + Wells
Attorney(s) for Defendant
American Investors Fund, Inc.

ONE (1) COPY
Service of ~~three (3) copies~~ of the within
APPENDIX is hereby admitted
this 8 day of April 1975
Rogers Hoge & Hills
Attorney(s) for defendant
Chestnutt et al.